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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1929.

No. 402.

THE UNITED STATES OF AMERICA,

Petitioner,

vs.

GUARANTY TRUST COMPANY OF NEW YORK, ET AL.,

Respondents.

On Writ of Certiorari to The United States Circuit Court of Appeals for the Eighth Circuit.

Petition for Certiorari Filed September 17, 1929, Certiorari Granted October 21, 1929.

BRIEF FOR W. H. KALBACH AND CLARA SHERIFF EXECUTORS OF THE ESTATE OF H. H. SHERIFF, A PRIORITY CREDITOR, RESPONDENT.

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INDEX.

Page.

Opinion Below 1
Statement of Facts 1
Jurisdiction 2
General History 2, 3
Statutes Involved 3
Contentions Stated 3
Claims Described 3, 7
Points and Authorities 7, 11
Argument 11
I. The Government has conceded that items 3 and 4, of Claim No. 2700 are not entitled to priority 11
II. What claims are entitled to priority 11
III. The right of the priority creditors constitutes an equitable lien superior to mortgages and other claims 13
IV. Priority under Section 3466 is not over liens antecedant to receivership 15
V. Priority under Section 3466 is inferior to equitable liens 15
VI. The Government claims are inferior to claims of priority creditors 17
VII. When the United States engages in private business it abandons its sovereignty and has no priority except as expressly reserved by Statute.
Priority Statutes to be construed strictly... 19
VIII. The United States is entitled to no greater consideration than a private citizen when it comes into court 24
IX. War Legislation is to be construed as a whole to find the broad purposes of Congress respecting priority.
The several Acts are Self-contained as to priority and Section 3466 does not apply.
The Government is estopped to claim priority under War Legislation. 25
A. Canons of Construction 25
B. Abstract of the Statutes 29
C. General Discussion 29
Appendix 47
Federal Control Act of March 21, 1918 47

Act of November 19, 1919 51
Transportation Act of February 28, 1920 53

TABLE OF CASES.

Brent v. Bank of Washington, 10 Peters 596, 9 L. Ed. 547 . . ..15, 25, 28
Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596 ...12, 13
Chicago & Alton R. R. Co. v. U. S. & Mexican Trust Co. 225 Fed. 940 (8th C. C. A.) 14
Conard v. Atlantic Insurance Co. of New York, 1 Peters 386 17
Cook County National Bank v. U. S., 17 Otto 445, 27 L. Ed. 537 . . ..22, 28
Davis v. Pringle (268 U. S. 315, 318, 69 L. Ed. 974) 20, 26, 27
Davis v. Michigan Trust Co. (2 Fed. 2d, 194, 197), (6th C. C.) 20, 27
Director General v. Kastenbaum (263 U. S. 25) 28
Fosdick v. Schall, 99 U. S. 252, 25 L. Ed. 596 .....12, 13
Gould v. U. S. Shipping Board, 261 Fed. 716, 718 (D. C. N. Y.) 23
Hemmer v. U. S., 204 Fed. 898 (8th C. C. A.) 25
Illinois Trust & Savings Bank v. Daud, 105 Fed. 123 (8th C. C. A.) 14
In re Eastern Shore Shipbuilding Corp., 274 Fed. 893. 23
Mellon v. Michigan Trust Co. (271 U. S. 236, 239, 70 L. Ed. 924) 20, 22, 26, 27, 28
Mitchell v. U. S., 9 Peters 711 25
Moore v. Donahoo, 217 Fed. 177 .....12, 13, 14
Mountain Copper Co. v. U. S., 142 Fed. 625 25
No. 34, 11 Fed. 287 (D. C. Mass.)..... 23
Salas v. U. S., 234 Fed. 842 23
Savings & Loan Society v. Multnomah County, 169 U. S. 421 17
Southern Railway Co. v. Carnegie Steel Co., 176 U. S. 257, 44 L. Ed. 458 .....12, 13, 14
Texas Co. v. International & G. N. Ry. Co., 237 Fed. 921 . . ..12, 13, 14
The Falcon, 19 Fed. 2d, 1009, 1013 (8), (D. C. Md.) .. 24
U. S. v. Guaranty Trust Co. (33 Fed. (2nd) 533) 13
U. S. v. Miller, 28 Fed. 2d, 846, 850, 8th C. C. A. 23
U. S. v. Planters' Bank of Georgia, 9 Wheat. 904 24
U. S. v. Skinner & Eddy Corp., 28 Fed. 2d, 373 24
U. S. v. Barker, 12 Wheat. 559, 6 L. Ed. 728 25

U. S. v. Smith, 4 Otto 214, 94 U. S. 214 25
U. S. v. Ingate, 48 Fed. 251 25
U. S. v. Detroit Timber & Lbr. Co., 131 Fed. 668 25
U. S. v. Clark, 138 Fed. 294 25
U. S. v. Oklahoma, 261 U. S. 253, 67 L. Ed. 642 15
Virginia & Alabama Coal Co. v. Central R. & B. Co., 170 U. S. 355, 42 L. Ed. 1068 .....12, 13, 14

STATUTES.

Federal Control Act of March 21, 1918; Public Laws 1917-1919, Vol. 40, Part I, Page 451.
Part of Sec. 6, all of Sec. 7, Parts of Secs. 8, 10, 12 and 14, and all of Secs. 15 and 16 (See Appendix) 47-51
Act of November 19, 1919.
Public Laws 1919-1921, Vol. 41, Part I, Page 359 (see Appendix) 51-53
Transportation Act of February 28, 1920
Ch. 91, Vol. 41, Stat. L. Page 456 53-60
All of Sec. 202, Part of Sec. 207, Part of Sec. 209 and all of Sec. 210 (As amended June 5, 1920) (See Appendix) 53-60
R. S. Sec. 3466 3

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Opinion in the Court Below Will be Found: United States v. Guaranty Trust Company of New York, 33 Fed. (2d) 533.

BRIEF FOR W. H. KALBACH AND CLARA SHERIFF EXECUTORS OF THE ESTATE OF H. H. SHERIFF, A PRIORITY CREDITOR, RESPONDENT.

STATEMENT OF FACTS.

The brief for the Government is not before us, having been delayed, and it is theretofore necessary to make statement of facts, including some facts omitted in the Government's brief in the court below.

The suit, being a creditor's bill, was commenced and a receiver thereunder appointed July 26, 1923 (R., p. 81, f. 115) by the Minneapolis Steel and Machinery Company, complainant (R., p. 1, f. 1), for exceeding $15,000.00 for labor, material, etc. (R., p. 1, f. 1) against the Minneapolis & St. Louis Railroad Company, a citizen of Iowa (R., p. 13, f. 16), to which bill the defendant answered admitting the complaint and joining in the prayer for relief (R., pp. 1 and 2, ff. 2 and 3), a receiver being immediately appointed (R., p. 81, f. 115), in which suit all of the mortgage trustees were subsequently made parties defendant and thereafter, under dependent suits, the mortgage trustees brought foreclosure proceeding, all of which were consolidated with the suit under the creditor's bill (R., p. 81, f. 115).

Claims were referred to Howard S. Abbott, Esquire, Special Master, and a large number of claims were established as priority claims, among which was the claim of this respondent (R., p. 80, f. 113); that is claims as for current expense of the road within the six months rule (R., p. 81, f. 115) and the Master determined that large sums had been diverted from current income during the six months preceding the receivership to the benefit of the mortgage trustees and that such funds should be restored from the mortgaged corpus for the payment of such priority claims (R., pp. 14 and 15, ff. 17 and 18).

All of the claims here involved arose out of Federal Control during the war including the Transportation Act of 1920.

These claims are described below and consideration must be given to all of them in construing the pertinent statutes. All of them were either disallowed or allowed as general claims only without priority by the Master, by the

District Court on exceptions to the Master's report (R., pp. 69-72, ff. 85-88) and by the Circuit Court of Appeals on appeal from the decree (R., pp. 81-91, ff. 114-129). Error is assigned to only Claim No. 2700, Item 1, 3 and 4 and Claim No. 4186.

The Government claims priority over liens of mortgagees and priority claims as well as general claims under U. S. Revised Statutes, Section 3466, which provides as follows:

> "Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

The priority creditors assert that the Federal Control Act of March 21, 1918, the Supplementary Act of November 19, 1919, the Transportation Act of February 28, 1920 (See Appendix for quotation of appropriate sections) are self-contained as to priority, that no governmental priority exists thereunder and that Section 3466 *supra* does not apply.

The priority creditors further contend that their liens are superior to the liens of the mortgages and that even if Section 3466 does apply, priority thereunder is inferior to all these liens.

The claims are as follows:

Item One—$1,382.00 note by the Railroad Company, dated April 1, 1921, due April 1, 1931, with interest at six per cent (6%) per annum (R., p. 4, ff. 5, 6).

This money was loaned to the Road by the Government under Section 210, Transportation Act of 1920, for the purpose of paying *a mortgage in that amount* on the part of the Road known as the "Pacific Extension Mortgage" (R., p. 4, ff. 5-8).

It was secured by collateral consisting of $2,377,000 of bonds under the Refunding and Extension Mortgage. Interest was paid on the loan to April 1, 1923 (R., p. 5, f. 6).

ITEM Two—Note for $386,190 (since reduced), dated July 1, 1921, due June 1, 1936, with interest at six per cent (6%), payable semi-annually (R., p. 5, ff. 6-8).

There is no assignment as to this Item, but its nature is necessary to the argument.

This note was given by the National Railway Service Corporation to the Government, payment guaranteed by the Road under Section 210, Transportation Act of 1920, as amended. It consisted originally of forty per cent (40%) of the purchase price of equipment, the total cost being $965,475, purchased for the Road by the National Railway Service Corporation under an equipment lease with certificates issued for the full amount of the purchase price. Forty per cent (40%) of these certificates were deferred, both as to principal and interest, as to security on the equipment. The Government took a pledge of the deferred certificates and a second lien upon $1,500,000 of the Road's refunding and extension bonds (R., pp. 5, 6, 7, ff. 6-8).

The contract was adopted by the receiver and all payments have been by him kept up (R., p. 6, f. 8). This claim was disallowed (R., p. 16, f. 20).

ITEM THREE—$625,000 note dated May 27, 1922, due March 1, 1930, to Director General, with interest at six

per cent (6%) per annum. This arose and was funded under (b) Section 207, Transportation Act of 1920, but arose under the Federal Control Act and is secured by $1,500,000 of the Road's refunding and extension bonds (R., p. 7, ff. 8, 9).

ITEM FOUR—$625,000 note dated April 1, 1923, due on demand, to Director General, with interest at six per cent (6%) per annum. This was funded under (d) Section 207, Transportation Act of 1920 as amended, but arose under the Federal Control Act and is secured by a junior lien on $1,500,000 principal of the Road's refunding and extension bonds (R., p. 7, f. 9).

The Master found that at the hearing before the Master the Government conceded that Items 3 and 4 were not entitled to priority (R., p. 15, f. 8), in this language:

> "I would also find that during the proceedings had at the time these claims were heard counsel for the Government stated in open court that the case of *Mellon, Director General v. Michigan Trust Company*, 271 U. S. 236, in which governmental priority was denied, would apply to claims No. 3268 and also to Items Nos. 3 and 5 of Claim No. 2700 for $625,000 each."

(The Master means, of course, Items Nos. 3 and 4.)

ITEM FIVE—$403,200 consisting of twelve notes, each $33,600, dated January 15, 1920, maturing annually from 1924 to 1935, inclusive, with interest at six per cent (6%).

These consist of deferred equipment trust certificates, deferred as to security out of a total issue of $1,512,000, the preferred certificate being privately held. This equipment was purchased during Federal Control and allotted to the Road under the Act of November 19, 1919, as well as the Federal Control Act (R., pp. 7 and 8, ff. 9, 10).

The equipment trust was adopted by the receiver under court order and payments have been kept up (R., p. 8, f.

10). The item was disallowed (R., pp. 16 and 17, f. 20). No error is assigned to this holding.

Due to illness of appellee's counsel while the Record was being prepared, the Record does not show the deferred and preferred certificates, but Government counsel will no doubt concede it, as they did in the court below.

Counsel will no doubt also admit that the deferred certificates held by the Government are endorsed as follows:

> "For value received and as an inducement to purchases of unstamped notes, the holder of this note has caused the same to be stamped pursuant to Article Eleventh of the Equipment Trust Agreement mentioned in the note, and, as provided in said Article Eleventh, the unstamped notes shall be payable in preference and priority to the stamped notes out of any moneys received or collected by the Trustee under said Equipment Trust Agreement upon enforcement of its rights or remedies in case of a default of the carrier."

CLAIM 4186.

$292,022.23 overpayment to the Road under estimates under guaranty provisions of Section 209, Transportation Act of 1920, but was a liability growing out of Federal Control Act. The question of amount of this claim is in litigation elsewhere, and at the hearing before the Master it was agreed that the Master should pass only upon the question of priority, the question of amount to be left open pending conclusion of other litigation (R., pp. 9 and 10, ff. 11 and 12). The claim is of course, secured as the Act requires.

The various divisional mortgages and foreclosures thereon are found by the Master (R., pp. 10 to 15, ff. 12 to 18).

Only the Refunding and Extension Mortgage need be noted here. It was given January 1, 1912, to secure an is-

sue of $75,000,000 bonds, of which $8,895,000 have been issued. It is a mortgage upon the entire Road (R., pp. 11 and 12, f. 14). The bonds here involved mature in fifty years (R., pp. 4, 5, f. 6).

POINTS AND AUTHORITIES.

I.

The Government has conceded that Items 3 and 4 of Claim No. 2700 are not entitled to priority.

Mellon, Director General v. Michigan Trust Company, 271 U. S. 236, 70 L. Ed. 924.

II.

What claims are entitled to priority.

Southern Railway Co. v. Carnegie Steel Company, 176 U. S. 257, 44 L. Ed. 458.

Fosdick v. Schall, 99 U. S. 252, 25 L. Ed. 342.

Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596.

Virginia & Alabama Coal Co. vs. Central R. & B. Co., 170 U. S. 355, 42 L. Ed. 1068.

Texas Co. v. International & G. N. Ry. Co., 237 Fed. 921.

Moore v. Donahoo, 217 Fed. 177.

III.

The right of the priority creditors constitutes an equitable lien superior to mortgages and other claims.

United States v. Guaranty Trust Co., et al., 33 Fed. (2d) 533, 539.

Fosdick v. Schall, 99 U. S. 252, 25 L. Ed. 342.

Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596.

Virginia & Alabama Coal Co. v. Central R. & B. Co., 170 U. S. 355, 42 L. Ed. 1068.

Southern Railway Co. v. Carnegie Steel Co., 176 U. S. 257, 44 L. Ed. 458.

Texas Co. v. International & G. N. Ry. Co., 237 Fed. 921.

Moore v. Donahoo, 217 Fed. 177.

Chicago & Alton R. R. Co. v. U. S. & Mexican Trust Co., 225 Fed. 940 (8th C. C. A.).

Illinois Trust & Savings Bank v. Daud, 105 Fed. 123 (8th C. C. A.).

IV.

Priority under Section 3466 is not over liens antecedent to the receivership.

United States v. Oklahoma, 261 U. S. 253, 67 L. Ed. 642.

Brent v. Bank of Washington, 10 Peters, 596.

V.

Priority under Section 3466 is inferior to equitable liens.

Brent v. Bank of Washington, 10 Peters, 596, 9 L. Ed. 547.

Conard v. Atlantic Insurance Co. of New York, 1 Peters 386.

Savings & Loan Society v. Multnomah County, 169 U. S. 421.

VI.

The Government claims are inferior to claims of priority creditors.

VII.

When the United States engages in private business it abandons its sovereignty and has no priority except as expressly reserved by statute.

Priority statutes to be construed strictly.

Mellon v. Michigan Trust Co., 271 U. S. 236, 239, 70 L. Ed. 924.

Davis v. Pringle, 268 U. S. 315, 318, 69 L. Ed. 974.

Davis v. Michigan Trust Co., 2 Fed. (3d) 194, 197, (6th C. C. A.).

Cook County National Bank v. United States, 17 Otto, 445, 27 L. Ed. 537.

Director General v. Kastenbaum, 263 U. S. 25, 28, 68 L. Ed. 146, 147, 44 Sup. Ct. Rep. 52.

Davis v. Pullen, 277 Fed. 650, 655, The No. 34, 11 Fed. (2d) 287.

United States v. Miller, 28 Fed. (2d) 846, 850.

Goul Coupler Co. v. U. S. Shipping Board E. F. Corp., 261 Fed. 716.

The Falcon, 19 Fed. (2d) 1009.

Standard Oil Co. v. United States, 267 U. S. 76, 45 Sup. Ct. Rep. 211, 69 L. Ed. 519.

In Re: Eastern Shore Shipbuilding Corp., 274 Fed. 893.

Salas v. United States, 234 Fed. 842.

United States v. Planters Bank of Georgia, 9 Wheat. 904.

United States v. Skinner & Eddy Corp., 28 Fed. (2d) 373.

VIII.

The United States is entitled to no greater consideration than a private citizen when it comes into court.

Hemmer v. United States, 204 Fed. 898.

Brent v. Bank of Washington, 10 Peters, 596.

United States V. Barker, 12 Wheat. 559, 6 L. Ed. 728.

United States v. Smith, 4 Otto, 214, 94 U. S. 214.

Mitchell v. United States, 9 Peters 711.

United States v. Ingate, 48 Fed. 251.

United States v. Detroit Timber & Lbr. Co., 131 Fed. 668.
United States v. Clark, 138 Fed. 294.
Mountain Copper Co. v. United States, 142 Fed. 625.

IX.

War Legislation is to be construed as a whole to find the broad purposes of congress respecting priority.

The several Acts are self-contained as to priority, and Section 3466 does not apply.

Government is estopped to claim priority under war legislation.

(A)

Canons of Construction.

Davis v. Pringle, 268 U. S. 315, 318.
Mellon v. Michigan Trust Co., 271 U. S. 236, 70 L. Ed. 924.
Cook County National Bank v. United States, 17 Otto 445, 27 L. Ed. 537.
Director General of Railroads v. Kastenbaum, 263 U. S. 25, 28, 68 L. Ed. 146.
Brent v. Bank of Washington, 10 Peters 596, 9 L. Ed. 547.

(B)

Abstract of the Statutes.

The Federal Control Act of March 21, 1918, Public Laws, 1917-1919, Vol. 40, Part 1, Page 451 (See Appendix).

The Deficiency Appropriation Act of June 30, 1919, Statutes at Large, Public Laws 1919-1921, Vol. 41, Part 1, page 34.

Act of November 19, 1919, entitled "An Act to provide for the reimbursement of the United States for motive power, etc." Public Laws 1919-1921, Vol. 41, Part 1, page 359 (See Appendix).

The Transportation Act of February 28, 1920, C. 91, 41 Stat. 456 (See Appendix).

(C)

GENERAL DISCUSSION.

ARGUMENT.

I.

The Government Has Conceded that Items 3 and 4 of Claim No. 2700 Are Not Entitled to Priority.

These two items consist of two notes for $625,000.00 each arising under the Federal Control Act and funded under Section 207 "(b)" and "(d)" respectively Transportation Act of 1920.

On the hearing before the Master, the Master finds that the Government conceded that these two claims as well as another claim arising under the Federal Control Act were not entitled to priority inasmuch as the items were governed by the case of *Mellon v. Michigan Trust Company*, 271 U. S. 236 (R., p. 15, f. 18).

In view of this concession the decision of the Circuit Court of Appeals should be affirmed in respect to these items.

II.

What Claims are Entitled to Priority.

It is a long and universally established doctrine that in liquidating or foreclosure receiverships against railroads and other public service corporations certain classes of claims are entitled to priority over mortgage liens and all other classes of claims. These claims consist of those

incurred within six months prior to the commencement of the proceedings for material, supplies and labor necessary to the continued operation of the road and to keep it a going concern and which were so incurred upon the express or implied agreement that the claims should be paid out of current income.

This priority extends to the gross prior to receivership operating current earnings (not "net earnings" as it is stated in the decision in the court below) and in addition thereto, to the net earnings of the receivership period as well as to the unmortgaged assets. If, during the six months prior to the appointment of a receiver the road has diverted moneys out of current earnings to the payment of mortgage principal or interest or to additions and betterments or to any other purpose benefiting the mortgagees the amounts so diverted must be restored for the benefit of the priority creditors from the corpus of the property if this course is necessary to pay the priority claims.

Southern Railray Co. v. Carnegie Steel Company 176 U. S. 257, 44 L. Ed. 458.

Fosdick v. Schall, 99 U. S. 252, 25 L. Ed. 342.

Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596.

Virginia & Alabama Coal Co. v. Central R. & B. Co., 170 U. S. 355, 42 L. Ed. 1068.

Texas Co. v. International & G. N. Ry. Co., 237 Fed. 921.

Moore v. Donahoo, 217 Fed. 177.

All parties herein concede the principles above stated.

III.

The Right of the Priority Creditors Constitutes an Equitable Lien Superior to Mortgages and Other Claims.

The priority stated under the foregoing head constitutes, under the authorities, an equitable lien. The Circuit Court of Appeals so decided in this case.

United States v. Guaranty Trust Co. et al., 33 Fed. (2d) 533, 539.

The lien rests upon contract because there can be no priority claim unless it was incurred, not upon the credit of the road, but on the understanding, express or implied, that it was to be paid out of current earnings.

Fosdick v. Schall, 99 U. S. 252, 25 L. Ed. 342.

Burnham v. Bowen, 111 U. S. 776, 28 L. Ed. 596.

Virginia & Alabama Coal Co. v. Central R. & B. Co., 170 U. S. 355, 42 L. Ed. 1068.

Southern Railway Co. v. Carnegie Steel Co., 176 U. S. 257, 44 L. Ed. 458.

Texas Co. v. International & G. N. Ry. Co., 237 *Fed.* 921.

Moore v. Donahoo, 217 Fed. 177.

In Fosdick v. *Schall, supra,* the court says that such claims must be paid "which in equity and good conscience considering the character of the business are chargeable upon such earnings".

In *Burnham v. Bowen, supra,* the Court says that "consequently, it almost always happens that current income is encumbered to a greater or less extent with current debts", etc.

It will be noted that in this case upon strict foreclosure the Court ordered the road to be again seized and sold

for the payment of priority claims. This, of course, could not have happened except upon the theory that the priority claims had a lien.

In *Virginia & Alabama Coal Co. v. Central R. & B. Co., supra,* the Court says that priority claims "might have been properly allowed as a charge upon the surplus income arising during the receivership".

In *Southern Railway Co. v. Carnegie Stell Co., supra,* the Court says, in speaking of diversions of income, "the mortgage security is chargeable in equity with the restoration of any funds thus improperly diverted from their primary use".

Again the Court says that "a superior equity arises in favor of the material men as against the mortgage bond in the income arising both before and after the appointment of a receiver," etc.

Again the Court says, "the equity thus held to arise", etc.

In *Texas Co v. International & G. N. Ry. Co., supra,* the income of the receivership was impounded in equity for the benefit of the priority creditors.

In *Moore v. Donahoo, supra,* it was held that a priority creditor could enforce his equitable lien independently of proceedings in mortgage foreclosure.

Chicago & Alton R. R. Co. v. U. S. & Mexican Trust Co., 225 Fed. 940 (8th C. C. A.).

Illinois Trust & Savings Bank v. Daud, 105 Fed. 123, (8th C. C. A.).

Suffice it to say that the rights of the priority creditors constitute an equitable lien.

The lien has priority in rank over all mortgages and other liens.

IV.

Priority Under Section 3466 is not Over Liens Antecedent to the Receivership.

Judicial decisions extending over one hundred years have established that the priority under Section 3466 does not create a lien, that it becomes effective only after divestiture of the insolvent *of his property* in one of the modes provided in the statutes, and that it is subordinate to prior liens.

The principle was fully reviewed in *U. S. v. Oklahoma*, 261 U. S. 253, 67 L. Ed. 642, and *Brent v. Bank of Washington*, 10 Peters 596.

It would be superfluous for us to add to the remarkable memorandum of the Master (R. pp. 23 to 41) with citation and quotations from authorities, and especially in view of the fact that a Brief on this point will be filed in behalf of the mortgage trustees.

If the position now taken by the Government is good law, then all opinions on abstracts of title rendered during the last one hundred years have been wrong.

V.

Priority Under Section 3466 is Inferior to Equitable Liens.

That priority under Section 3466 is inferior to an equitable lien has been fully established in the Federal Supreme Court.

In the case of *Brent v. The Bank of Washington*, 10 Peters 596, 9 L. Ed. 547, the court held that the priority of the United States does not displace an equitable lien or a special equity of a claimant against property in the

hands of an insolvent at the time of divestiture within the meaning of the priority statute. In that case, a by-law of the Bank of Washington provided:

> "But all debts actually due and payable to the Bank (days of grace for payment being past) by a stockholder requesting a transfer, must be satisfied before such transfer shall be made unless the president and directors shall direct to the contrary."

The decedent, Brent, whose estate was insolvent and who was largely indebted to the Government,, owed several notes which had gone to protest at the time of his death and also owed certain debts to the bank which were not then due.

It follows, and the decision of the Court proceeds upon the theory that as to the notes not due there was no *preferred lien and that the bank had a mere equity.*

The executors brought suit against the bank to compel a transfer of decedent's stock therein discharged the lien of the bank, basing their suit in equity upon the ground that Brent was indebted to the United States and that the indebtedness took priority.

The Courts held that the action was necessarily equitable inasmuch as the executor had no means of compelling the transfer at law, and that the action, being equitable, was governed by equitable principles.. The Court says:

> "In good conscience there can be no claim more equitable than that of the bank for money lent, and if the law has placed them on the *tabula in naufragio*, it little comports with the principals of equity to take it from them merely because, by the death of Mr. Brent before the protest of the third note, the legal lien, secured by their charter, had not become consummated before the legal right of the United States had attached to priority of payment out of his estate. An individual asserting such a claim in equity against the bank, in virtue of an act of bankruptcy an execution or assignment, between the date and the protest of the note, *would be compelled to do*

> *equity* before he could enforce his legal right; and we can perceive *no reason why the United States should be exempted* from this fundamental rule of equity, subject to which, its courts administer their remedy." (Italics ours.)

The Court says again:

> "The principle of these cases covers the present in all its bearings. It is admitted that the bank have a legal right to withhold the transfer till payment of the notes protested in the lifetime of Mr. Brent; the case is equally clear in equity as to the notes indorsed by him and discounted by the bank though not protested till after his death."

See also:

Conard v. Atlantic Insurance Co. of New York, 1 Peters 386.

Savings & Loan Society v. Multnomah County, 169 U. S. 421.

VI.

The Government Claims are Inferior to Claims of Priority Creditors.

The property of the defendant railroad is subject to mortgage liens which amount, with accrued interest to approximately $56,000,000.00 (R., p. 60, ff. 73, 74). These originated prior to Federal Control. It is likewise conceded and it was found by the Master that it is improbable that the property of the railroad will sell at foreclosure sale for more than the amount of the mortgage indebtedness with accrued interest (R., p. 60, f. 74).

This being the situation it remains to inquire by what means in the light of the foregoing well established principles the Government can displace the priority creditors. The funds out of which the priority creditors must be paid, if at all, consist of funds restored out of the corpus to make

good diversions of income for the benefit of the mortgagees during the six months prior to receivership period, cash and prior to receivership operating income coming into the hands of the receiver at the time of his appointment, net income of the receiver and unmortgaged assets. The lien of the mortgages entrusts to all these items. Net income of the receiver is negligible (R., p. 60, ff. 73, 74).

We may then best illustrate the situation here by an example:

Assume a railroad receivership with a mortgage indebtedness of $40,000,000.00; assume prior to receivership diversions of income $500,000.00 and no receiver's net income; assume priority claims of $1,000,000.00; assume a sale for $40,000,000.00, the amount of the mortgage debt.

Obviously in such a case the priority creditors would receive fifty per cent or $500,000.00 and the mortgagees $39,500,000.00; but if there were no priority claims the mortgagees would receive the whole $40,000,000.00 inasmuch as their lien would extend to the entire sum.

We inquire by what reasoning the Government could, under these circumstances, take the funds which in any event would belong to the mortgagees.

But if in the same example we assume no prior to receivership diversions, a net income of the receiver of $500,000.00, sale for $39,500,000.00, the result would be the same. The mortgagees would in these circumstances take the net income under their lien, but for the equitable lien of the priority creditors.

If in either case the road were sold on foreclosure for an additional $500,000.00, the situation as to the Government would still remain unchanged. In either such case the mortgagees would, of course, be paid in full and the priority creditors fifty per cent.

The liens of the priority creditors are superior to the mortgagees. The mortgagees would take whatever the priority creditors did not take.

VII.

When the United States Engages in Private Business It Abandons Its Sovereignty and Has No Priority Except as Expressly Reserved By Statute.

Priority Statutes to be Construed Strictly.

The claims here in question arose under and out of Federal Control.

The President under statutory authority took over the railroad corporations of the country and their properties, and operated them during the war and for some time after hostilities ceased.

So far as the questions here involved are concerned, there can be no distinction between this method of handling private business and entering that field through the Shipping Board and the Emergency Fleet Corporation.

As we shall see later, congressional policy as evidenced by statutes, as well as the executive policy thereunder, was to leave the relations and rights of private citizens as little disturbed as possible during Federal Control; to invite and induce the general public to finance railroad companies in respect to the purchase of securities, the extension of credit for supplies and material, etc., as far as possible, and under the same conditions as during private operation; to furnish from the Government treasury only such necessary financial aid to the railroads as could not be procured from private sources, and for this purpose a total governmental revolving fund of $1,750,000,000 was provided.

In its relationships to the public the United States must be regarded as a *quasi* owner during Federal Control. It did what directors and stockholders of corporations often find it necessary to do, loaned money and extended credit to the corporations it was operating only so far as it could not borrow the money elsewhere for them. Such extensions of credit were virtually capital investment by the Government.

We are now met with the startling proposition that the Government could thus invite and induce the public to extend credit to governmental agencies and afterwards, when the agency becomes financially embarrassed, the Government can step in and absorb the assets in advance of private creditors, even those who are secured, for advances (similar to those that might be made by stockholders or directors) made by it only because they were necessary to keep the governmentally operated road going and because private investors refused to furnish the funds. We cannot conceive that the Federal Courts will sustain the Government in this position, unless they are compelled to do so by clear and convincing provisions in Federal Statutes. The priority of the United States must rest upon statutory provisions and not upon governmental prerogative.

In *Mellon v. Michigan Trust Co.* (271 U. S. 236, 239, 70 L. Ed. 924), the court said:

> "All agree that the rights of the Director General rests upon statutory provisions and not upon any sovereign prerogative of the United States."

Moreover, the Federal Courts in later years have tended to restrict, rather than to extend, Federal Priority. There has been a change in public pinion, which is reflected in the decisions, in respect to this priority particu-

larly due to the vast extension of governmental activities and the frequency with which the priority statutes operate unjustly to the citizen.

In *Davis v. Pringle* (268 U. S. 315, 318, 69 L. Ed. 974) the court in passing upon governmental priority under the Bankruptcy Act and the changes therein from earlier Acts says:

> "Public opinion as to the peculiar rights and preferences due to the sovereign has changed."

It was held in that case that the governmental priority was strictly limited to the priority granted by the Bankruptcy Act, and that Section 3466 did not apply.

The court having in mind this change in opinion and applying the rule of strict construction, says (p. 318):

> "We attach little value to this logical concatenation as against the direct effect of §64, taken according to the normal usages of speech. It is incredible that after the conspicuous mention of the United States in the first place at the beginning of the section and the grant of a limited priority, Congress should have intended to smuggle in a general preference by muffled words at the end. The states are mentioned in (5) before the United States, showing that their laws were primarily in mind."

In *Davis v. Michigan Trust Co.* (2 Fed. 2nd, 194, 197) (6th C. C.) the court says:

> "Judicial opinion as well as legislation is examining anew the proper privileges and immunities to be accorded the sovereign state, and in cases not clearly covered by statute or decision the correct solution is not to be found by the application of an abstract formula, but by the most careful consideration of the public needs and the practical requirements of law in the modern industrial community."
>
> "Giving due regard to the expression of congressional policy of priority, on the one hand, and of a restriction to the rights that the carrier theretofore enjoyed, on the other hand, and on a careful balancing of

> conflicting interests, we believe that, especially in the light of the policy of the present Bankruptcy Act as interpreted by the Chief Justice, *supra*, priority must be denied to the Director General in this case."

In *Cook County National Bank v. U. S.*, 17 Otto 445, 27 L. Ed. 537, it was held that the National Banking Act contained its own priority provisions and that Section 3466 did not apply.

The foregoing authorities are to the effect that a stricter rule of construction on the question of governmental priority and prerogative is necessary at this time than has heretofore been applied; that especially when the Government enters the field of private business or commercialism it surrenders its sovereignty and becomes a private citizen; that priority under these circumstances will not be granted unless compelled by the strict language of the applicable statutes; that Section 3466 will not be applied where any other conclusion is possible.

In *Melon v. Michigan Trust Co., supra* (271 U. S. 236, 239) the court said:

> "In some matters, at least, under §10, the United States stands exactly as if they were a railroad corporation operating as a common carrier. *Director Gen. v. Kastenbaum*, 263 U. S. 25, 28, 68 L. Ed. 146, 147, 44 Sup. Ct. Rep. 52. As said in *Davis v. Pullen* (C. C. A. 1st), 277 Fed. 650, 655, 'there is a certain obvious injustice in giving the United States when engaged in an industrial venture, even although under war powers, superior rights over other creditors bearing like relations to insolvents.' And we think that the indicated purpose of Congress will be best carried out by construing the relevant statutes, so far as may be, with the general intent to preserve the substantive rights of all parties concerned as they would have existed but for Federal Control."

In *The No. 34*, 11 Fed. (2d) 287 (D. C. Mass.) the court says:

> "I understand the law to be that when the United States engages in a business enterprise it is subject to the same conditions as private citizens."

In *U. S. v. Miller*, 28 Fed. 2nd, 846, 850 (8th C. C. A.) the court says:

> "* * * or when the United States steps down from its plane of sovereignty and enters the domain of business and commerce, such as operating merchant vessels by a Shipping Board, or running railroads, or going into the insurance business. When this is done, it may well be claimed that it has abandoned its sovereignty and submitted itself to the same laws that govern individuals engaged in that business. *Goul Coupler Co. v. U. S. Shipping Board E. F. Corp.* (D. C.), 261 F. 716; *The No. 34* (D. C.), 11 F. (2d) 287; *The Falcon* (D. C.), 19 F. (2d) 1009; *Standard Oil Co. v. United States*, 267 U. S. 76, 45 S. Ct. 211, 69 L. Ed. 519."

In *Gould v. U. S. Shipping Board*, 261 Fed. 716, 718 (D. C. N. Y.) Judge Hand says:

> "Moreover, it is in general highly desirable that, in entering upon industrial and commercial ventures, the governmental agencies used should, whenever it can fairly be drawn from the statutes, be subject to the same liabilities and to the same tribunals as other persons or corporations similarly employed. The immunity of the sovereign may well become a serious injustice to the citizen, if it can be claimed in the multitude of cases arising from governmental activities which are increasing so fast. At least I have no disposition to strain the point in their favor, where they fall clearly within the principle of authoritative decisions."

To the same effect are the following cases:

In re Eastern Shore Shipbuilding Corp., 274 Fed. 893.
Sales v. U. S., 234 Fed. 842.

U. S. v. Planters' Bank of Georgia, 9 Wheat. 904.
The Falcon, 19 Fed. 2d, 1009, 1013 (8), (D. C. Md.).
U. S. v. Skinner & Eddy Corp., 28 Fed. 2d, 373.

It follows from the foregoing authorities that the rule of strict construction must be followed in the present situation; that priority should not be allowed to the Government unless the applicable statutes compel such construction; that the Government stands as a private citizen in this case unless it has by statute expressly reserved its sovereign and priority status.

Weight must also be given to the circumstance that no priority such as here claimed was in contemplation of Congress when Section 3466 was enacted. This is clearly suggested by the foregoing authorities.

The modern private activities of the Government are so far beyond anything that was even remotely dreamed of at that time.

Strict construction is in these days required in the public interest, at least in respect to private ventures by the Government.

VIII.

The United States is Entitled to No Greater Consideration than a Private Citizen When it Comes Into Court.

The proposition is so well and so firmly established that when the Government becomes a party litigant in a court it is entitled to no greater consideration than the most humble private citizen. Furthermore, when it comes into equity it must do equity.

We call attention to the Master's memorandum (pages 58 to 60):

"In Equity Cases the Government Stands on Parity with Other Litigants."

and the authorities there cited.

These authorities sustain the principle:

Hemmer v. U. S., 204 Fed. 898 (8th C. C. A.).
Brent v. Bank of Washington, 10 Peters 596.
U. S. v. Barker, 12 Wheat. 559, 6 L. Ed. 728.
U. S. v. Smith, 4 Otto 214, 94 U. S. 214.
Mitchell v. U. S., 9 Peters 711.
U. S. v. Ingate, 48 Fed. 251.
U. S. v. Detroit Timber & Lbr. Co., 131 Fed. 668.
U. S. v. Clark, 138 Fed. 294.
Mountain Copper Co. v. U. S., 142 Fed. 625.

IX.

War Legislation is to Be Construed as a Whole to Find The Broad Purposes of Congress Respecting Priority.

The Several Acts Are Self-Contained as to Priority and Section 3466 Does Not Apply.

Government is Estopped to Claim Priority Under War Legislation.

(A)

Canons of Construction.

Preliminarily, in construing the war legislation these considerations are important:

(a) Manifestly, in the passage of the Transportation Act, Congress did not have in mind any change of intention or policy as to Governmental priority from that evidenced in the Federal Control Act, nor is there any such change

intended from section to section in the Transportation Act. If there had been such change Congress should and would have plainly said so and not by "muffled words at the end."

Davis v. Pringle, 268 U. S. 315, 318.

If there is no priority under the Federal Control Act it follows that there should be none under the Transportation Act unless its language compels this construction.

(b) The Federal Supreme Court has already held that the Control Act (which applies equally to the Transportation Act) must be construed on the question of priority in accordance with the broad purposes of Congress; that such purposes indicate that no priority was intended. The broad purposes are, of course, the general welfare of the people.

In *Mellon v. Michigan Trust Co.* (271 U. S. 236—70 L. Ed. 924) the question was whether the Director General had priority under Section 3466 as to indebtedness owing to him or his carrier by a private insolvent. The court said:

> "To permit the claim preference, we think would conflict with the spirit and broad purpose of the statute. These become plain enough upon consideration of the just ends which Congress had in view together with the recent policy revealed by the Banking Act in respect to priority."

We perceive no difference in the reasoning of that case when applied to the insolvency of the carrier. Surely the Government could not claim priority over a debt incurred prior to Federal Control, whether secured or unsecured, for the Act contemplated that all of these should be paid in due course.

The Government counsel conceded before the Master that the *Mellon* case, *supra,* applied to the two $625,000.00 notes.

The Master found as follows:

> "I would also find that during the proceedings had at the time these claims were heard counsel for the government stated in open court that the case of *Mellon Director General v. Michigan Trust Co.*, 271 U. S. 236 in which governmental priority was denied, would apply to Claims No. 3268 and also to Items Nos. 3 and 5 of Claim No. 2700 for $625,000.00 each" (R., p. 15, f. 18) (The Master means Items 3 and 4, R., p. 7, ff. 8, 9).

As to the two $625,000.00 notes, both arose out of Federal Control, one funded under "(b)," Section 207 Transportation Act of 1920, and one funded under "(d)," Section 207, Transportation Act of 1920. The result is that the Government concedes in principle that all Government claims against railroads which arose under the Federal Control Act are not entitled to priority under the provisions of that Act as construed in the *Mellon* case, *supra.*

(c) In construing the acts consideration should be given to the question whether the broad purposes of Congress could have been attained if these acts had specifically provided for Government priority.

(d) It must be assumed that Congress knew the decisions in the Federal Courts relating to the lien of priority claimants.

(e) The change in Federal judicial and legislative attitude as hereinbefore shown toward priority and prerogative—the new rule of strict construction at least when the Government engages in private business, must be remembered.

Mellon v. Michigan Trust Co., 271 U. S. 236, 70 L. Ed. 924.

Davis v. Pringle, 268 U. S. 315, 318, 69 L. Ed. 974.

Davis v. Michigan Trust Co., 2 Fed (2d), 194, 197.

Cook County National Bank v. United States, 17 Otto 445, 27 L. Ed. 537.

(f) The Government was engaged in private business.

Mellon v. Michigan Trust Co., 271 U. S. 236.

Director General of Railroads v. Kastenbaum, 263 U. S. 25, 28, 68 L. Ed. 146.

In the latter case, the court said:

> "The Government under Section 10 (Federal Control Act) in a case of false imprisonment, stands exactly as if it were a railway corporation operating as a common carrier." (Parenthesis ours.)

(g) The fact that these Acts contained their own provisions for security to the Government of its own selection is also of great force.

In *Cook County National Bank v. United States, supra,* the question was whether Section 3466 applied to an insolvent national bank in view of the provisions of the Banking Act.

The Supreme Court said:

> "With these provisions for security against possible loss for moneys deposited, it would seem only equitable that the Government should call for such security and, if it prove insufficient, take the position of other creditors in the distribution of the assets of the bank in case of its failure."

(h) The Government has no preference over its citizens in its own courts. It must do equity.

Brent v. Bank of Washington, 10 Peters 596, 9 L. Ed. 547.

(i) It was the manifest purpose of Congress, especially in the Transportation Act, to build up and maintain the credit of carriers from private sources. The intention was that the Government should finance only what the public ought not and refused to finance.

(j) The conditions produced by the war, the economic disturbances to carriers as well as the country in general, the impending breakdown of transportation, the circumstances under which Congress acted, must be remembered.

B.

Abstract of the Statutes.

The pertinent statutes are:

(1) The Federal Control Act of March 21, 1918, Public Laws, 1917-1919, Vol. 40, Part 1, Page 451 (See Appendix).

(2) The Deficiency Appropriation Act of June 30, 1919, Statutes at Large, Public Laws 1919-1921, Vol. 41, Part 1, Page 34.

(3) Act of November 19, 1919, entitled "An Act to provide for the reimbursement of the United States for motive power, etc." Public Laws 1919-1921, Vol. 41, Part 1, page 359 (See Appendix).

(4) The Transportation Act of February 28, 1920, C. 91, 41 Stat. 456 (See Appendix).

Federal Control Act Mar. 21, 1918:
(As amended Mar. 2, 1919)

Section 6: Revolving fund of $500,000,000, plus surplus railroad income created, to provide for expenses of Federal Control, terminals, motive power, cars, equipment.

President authorized to make additions, betterments, road extensions, provide terminals, motive power, cars, and other equipment.

May make advances from the revolving fund for these purposes and interest at such rate and on such terms as the President determines "to the end that the United

States may be fully reimbursed for any sums so advanced."

Section 7. To provide funds for maturing obligations and for other legal and proper expenditures or for reorganizing railroads in receiverships. Carriers authorized to issue bonds, notes, equipment trust certificates, stock and other forms of security, secured or unrecured, by mortgage, as the President "may first approve and consistent with the public interest."

President authorized to purchase out of the revolving fund all or any part of such securities at not exceeding par *and* to *sell* them at not less than cost when in his judgment desirable.

"Any securities so purchased shall be held by the Secretary of the Treasury who shall, under the direction by the President, represent the United States in all matters in connection therewith *in the same manner as a private holder thereof.*"

Section 10. Provides that while under Federal Control carriers are subject to the laws and liabilities as common carriers both under State and Federal law except as may be inconsistent with Federal Control Act and orders of the President.

Actions at law and suits may be brought by and against carriers and judgments rendered as now provided by law.

No defense because governmental instrumentalities.

Jurisdiction of Federal Courts and removability same as before Federal Control.

Section 12. Moneys and income from operation is property of the United States not covered into the Treasury but accounting as usual.

Disbursements without appropriation are to be made for items chargeable to operating expenses under I. C. C. rules, railway tax accruals and for such other purposes as the President may direct.

Balances are covered into the Treasury to the credit of the revolving funds. Deficits are paid out of the revolving fund.

Section 14. To continue during the war, and a limited time thereafter, subject to earlier terminatiton by the President.

Section 15. State taxes and police powers same as before Federal Control.

Section 16. Emergency legislation and not declaration of policy as to Government ownership.

Act of June 30, 1919:

Appropriates an additional $750,000,000 for revolving fund.

Act of November 19, 1919:

The title is "Act to Provide *for the Reimbursement of the United States* for Motive Power, Cars and Other Equipment ordered for Railroads and Items of Transportation under Federal Control and for Other Purposes" (Italics ours).

Provides for accepting, for these purposes, cash or shares of stock or obligations, secured or unsecured, of any corporation not a carrier organized for the purpose of owning equipment or equipment obligations, etc.

The National Railway Service Corporation was organized under this provision.

The Act specifically provides that it is an enlargement of the powers conferred by Section 6 of the Federal Control Act and so recites.

The President is fully authorized to sell obligations acquired by the Government.

Is declared emergency legislation.

Transportation Act of 1920:

Section 200. Terminates Federal Control March 1, 1920.

Section 202. Authorizes the President, upon termination of Federal Control to adjust, settle, liquidate and wind up all matters arising out of Federal Control, compensation to carriers and all questions relating to Federal Control.

Appropriates $200,000,000 to be added to the revolving fund, all of which is available for purposes of the Act.

Section 207. Provides for adjustment of debts by the President after termination of Federal Control. The items are:

(1) Additions and Betterments paid by United States.

(2) Other indebtedness to United States.

(3) The indebtedness of United States to the Carriers.

Paragraph (3) may be offset against (1) and (2) "*so far as deemed wise by the President,* but only to the extent permitted under any contract now or hereafter made • • • in respect to matters of Federal Control"; where no contract exists, then only to the extent permitted under paragraph (b) of Section 7 of the Standard Contract.

But the right of setoff must not be so exercised to prevent carrier from having enough for interest, taxes and other corporate charges and expenses referred to in paragraph (b) of Section 7 of the Standard Contract, accruing during Federal Control and dividends declared during Federal Control and accruing between the last payment and termination of Federal Control; and

Such *further working capital* equal to one-twenty-fourth of operating expenses for 1919.

Paragraph (b). Debts for additions and betterments funded for ten years or less at option of carrier, six per cent interest, terms on or before payment, security in such form and upon such terms as the President may prescribe.

Paragraph (c). Car Trust Certificates entered into shall not be refunded.

Paragraph (d). Other indebtedness due one year from termination of Federal Control; interest six per cent secured by such collateral as the President "may deem it advisable to require."

Paragraph (e). President authorized to grant extensions of time of, and to exchange all securities as may to him seem desirable.

Paragraph (f). Carriers authorized to issue Equipment Trusts to the Government for allocated equipment.

Paragraph (g). No authorization, State or Federal, required for loans.

Section 209. Provision for governmental compensation to railroads on the determined basis of earnings during the guaranty period.

The government paid to the M. & St. L. a very large sum in fulfillment of this guaranty.

(h) Advances on estimate are to be made to carriers on security for repayment to the Government of excess over amount finally found due.

Section 210. (As amended June 5, 1920).

(a) "For the purpose of enabling carriers by railroad subject to the Interstate Commerce Act *properly*

to serve the public during the transition period immediately following the termination of Federal control";

Carriers may, with two years, apply to I. C. C. for a loan from United States "to meet its maturing indebtedness or to provide itself with equipment or for other additions and betterments."

Must show property ownership, indebtedness, contract obligations, earning power and other facts relating to *propriety and expediency of granting loan* and the ability of applicant to make good the obligation.

(b) If I. C. C. finds loan necessary to enable "the applicant *properly to meet the transportation needs of the public* and that the prospective earning power of the applicant and the character and value of the security offered are *such as to furnish reasonable assurance* of the applicant's ability to repay the loan within the time fixed therefor and *to meet its other obligations* in connection with such loan" the Commission shall certify to the Secretary of the Treasury its finding of such fact, and certain other matters, including "that the prospective earning power of the applicant, together with the character and value of the security offered, furnish, in the opinion of the Commission, *reasonable assurance* of the applicant's ability to repay the loan within the time fixed therefor and *reasonable protection to the United States;* and that the applicant, in the opinion of the Commission, *is unable to provide itself with the funds necessary for the aforesaid purposes from other sources."* (Italics ours.)

(c) $300,000,000 appropriated as revolving fund for new loans.

(d) I. C. C. authorized to take advice from Federal Reserve Board.

C.

General Discussion.

The war legislation covers the question of Federal priority inferentially.

Necessarily, construction must be arried at in the light of the well known surrounding circumstances, in view of which the "broad purpose" of Congress in all of the legislation is clear and readily ascertained.

Shortly after the outbreak of the war, the President found it necessary to take control of the railroads under a very general authorization passed some years before. This was necessary, not only for transportation of troops and war materials, but in order to prevent a breakdown of carriers during the war which would have frozen the resources of the country and resulted in an economic catastrophe.

Under the pressure of the multitudinous legislation required by the war, Congress in March, of 1918, enacted the Federal Control Act.

It authorized the continuance of Federal control during the war, and for a limited time thereafter, but vested authority in the President to surrender Federal control earlier in his discretion.

It provided that the earnings of railroads during Federal control should be property of the United States, and, except for surplus earnings, should not be covered into the Treasury, but used as usual. The surplus income of the stronger roads, after certain charges thereon, was to be covered into the Treasury to the credit of the revolving fund.

A revolving fund of $500,000,000 plus surplus earnings was created, later by the act of June 30, 1919 increased to $1,250,000,000 and ultimately by the transportation

Act increased by another $500,000,000, making a total of $1,750,000,000.

Of this revolving fund the President was authorized to use $1,250,000,000 plus surplus income appropriated prior to the Transportation Act for these purposes:

(1) For the expenses of maintenance and operation.

(2) For maturing obligations, extensions, improvements, betterments, terminals, motive power, equipment, reorganization of roads in receivership and other purposes in the public interest.

The President was further authorized to cause the railroads to issue bonds, equipment trusts and all other classes of railroad securities, secured by mortgages and liens upon the carriers and unsecured as he might determine, for all these purposes including the meeting of maturing obligations, the reorganization of railroads in receivership, and to acquire for the Government out of the revolving fund any securities so issued, with the provision that the Secretary of the Treasury should hold the same for the United States "*the same as a private holder.*"

These securities the President was authorized to sell to the general public as he might determine.

The definite language of the statute in its provision that the Secretary of the Treasury should hold the same in the *same manner as a private owner* fully shows that no governmental priority was intended.

Furthermore, it was plainly the intention of Congress that the revolving fund should be used for these purposes only to the extent necessary, and that the public should be induced to extend credit, both secured and unsecured, to the railroads as far as possible, in order that undue strain upon the public treasury might be avoided. It was the intention that the Government should take and hold

only those securities *that could not be sold to the public.* It was not the intention that the Government should be responsible to private owners for securities issued by the railroads during Federal control.

Obviously, the Government could have caused a carrier to make a bond issue, secured by mortgage, could have financed initially the bond issue through the revolving fund, and might have sold half of the issue, retaining the other half, thus placing itself on a parity as to security with the private holder.

In the instant case, in both of the equipment trusts the Government did just that, with his qualification: It took equipment certificates for the initial cash payment of from twenty to forty per cent of the purchase price usually required by the manufacturer. It made these certificates those last maturing, and it made them inferior in lien, both as to principal and interest, to the remainning sixty to eighty per cent sold to the general public.

It is pertinent to here inquire what would have been the position of the Government had there been default in one of these equipment trusts, foreclosure of the security, and not enough realized to pay the preferred certificates. Supposing in such case the preferred certificate holders as well as the Government had come into this proceeding and presented their claim for deficiency. Under those circumstances could the Government, which had contracted to stand aside as to security, claim a preference over the preferred certificate holders as to the deficiencies?

It was likewise the intention of Congress that payments maturing upon all railroad securities, as well as unsecured obligations issued and incurred before Federal Control, including all taxes, should be kept up whether the carriers were solvent or insolvent, even if it had to be done out of the revolving fund.

This is exactly what was done, and any other course would have created a financial panic.

Suppose a liability for personal injury or other unsecured claim accruing before Federal control were not liquidated until after Federal control and a receivership. Could the Government now step in and say that it intended in the Federal Control Act to reserve priority over such a claim?

The intention of Congress is in fact made quite plain by the provision that the securities are to be held by the Secretary of the Treasury the same as a private holder.

In this connection we call attention to the title of the Act of November 19, 1919, which begins: "An Act to provide *for the reimbursement of the United States* for motive power, etc.," evidencing the intention of Congress to incorporate the entire provision as to how the United States was to be reimbursed.

We also direct special attention to the provisions of Section 10 of the Control Act as construed in the Mellon case, *supra.*

Obviously no Federal priority was intended under any of these enactments. Had the Act specially so provided it would have defeated the purposes of Congress, for the public would have been alarmed as to the value of railroad securities and credit.

It should furthermore be observed that these statutes contain their own provisions for security to the Government, although the taking of security was wholly a matter of discretion during the war, as it necessarily had to be.

Coming now to the Transportation Act of 1920, it is well to recall the circumstances under which Congress acted.

All will remember the debilitation of the property of carriers, rolling stock and roadbeds, during Federal Control. All will remember the strain upon carriers, their inability to meet public demands during the years 1919 and 1920.

There had also been great dislocation in the movement of traffic.

Hostilities had ceased November 11, 1918, but final peace was long in the making, and while the necessity for Federal Control had ceased, the President found himself unable with safety to the public to return the carriers to private ownership and operation. There was great danger of breakdown in transportation, with the resultant catastrophe to the country. Many of the roads were facing insolvency unless the Government should come to the rescue.

Under these circumstances Congress enacted the Transportation Act of 1920, terminating Federal Control.

It is impossible to read this legislation without coming to the conclusion that the "broad purpose" of Congress was to rehabilitate the carriers, to put them on their feet financially, to reestablish their ability to finance themselves from private sources.

Congress added $200,000,000 to the revolving fund, which was already $1,250,000,000, plus surplus and earnings, for the purpose of funding the indebtedness of carriers to the Government. It created another revolving fund of an additional $300,000,000 for the financing of new and additional loans to carriers.

It empowered the President to adjust the indebtedness of carriers to the Government, and it prohibited the Government from exercising its right of setoff in full and required that it should be made only *as deemed wise* and that the carriers should be left in funds sufficient to meet

operating expenses for a limited period, and even to pay certain dividends, and maturing interest, taxes, etc.

It required the President to fund the indebtedness of carriers to the Government at the option of the carriers, in most cases for a period of ten years, in some cases for shorter periods, and empowered the President to extend the time on all of these securities.

It required (and in this it differed from the Control Act) that these several indebtednesses should be secured as the President might determine, which meant, of course, that while the President was required to extend time, the roads were to give security such as might be available and chosen by the President.

It must be remembered that all of this indebtedness so funded originated under the Federal Control Act, and could have been represented by securities taken to the Government under the provisions of that Act.

The two $625,000 notes, and we think, also the claim for $292,022.23, Claim No. 4186, *originated directly under the Federal Control Act.*

As to these indebtednesses, it is inconceivable that if Congress did not intend governmental priority under the Control Act it could have changed its intention under the Transportation Act, and forgotten to say so. Had there been any such intention Congress would have plainly said so, not "by muffled words at the end."

The very purpose of funding this vast indebtedness was to avoid the consequences which would have ensued had the Government demanded the immediate payment. The further purpose was plainly to reestablish the private credit of the carriers, to reassure the public, and to induce the extention of such credit from private sources as far as possible.

For all of these purposes the President was authorized to utilize the vast revolving fund consisting as a whole of $1,450,000,000 and the surplus earnings.

The Government was entering the field of private investment for unsalable securities.

But this is not all. Under Section 210 of the Transportation Act (e) an additional revolving fund of $300,000,000 is provided.

It further provides (a) "for the purpose of enabling carriers by railroad subject to the Interstate Commerce Act properly to serve the public *during the transition period immediately following the termination of Federal Control*" (italics ours), the President might make loans out of this revolving fund to carriers within two years after termination of Federal Control, to enable carriers to meet their maturing indebtedness, and provide themselves with equipment, additions and betterments.

These loans were to be approved by the Interstate Commerce Commission, which in turn was authorized to take the advice of the Federal Reserve Board.

The Commission must find (b) that the loan was necessary to "enable the applicant properly to meet the transportation needs of the public"; that the earning-power of the carrier, the offered security, furnish reasonable assurance of the carrier's ability to repay at maturity, "and *to meet its other obligations* in connection with such loan." Terms could be fifteen years. There must be reasonable assurance of the applicant's ability to repay and "*reasonable protection to the United States,*" and, *most important,* the Commission must find that the carrier "*is unable to provide itself with the funds necessary for the aforesaid purposes from other sources*" (Italics ours).

In other words, the Government of the United States

in making these loans exercised not sound business judgment as an investor, *but was to take such securities as could not be privately sold* and the sale of which was necessary in the public interest. Its larger purpose was the general welfare of the public, the maintenance and reestablishment of the credit of carriers and the prevention of a panic.

In the instant case the carrier under these provisions borrowed $1,382,000 (Claim 2700, Item 1) for the purpose of meeting the then maturing underlying *Pacific Extension Mortgage* on a part of its road.

Item 2 of Claim number 2700 was likewise financed by the Government under the provisions of Section 210 of the Transportation Act (R., p. 5, ff. 6-8) for the purchase of fifteen locomotives (R., p. 6, f. 8) purchased under an Equipment Trust for the entire purchase price, preferred certificates for sixty per cent thereof being sold to the public and the remaining forty per cent deferred as to security were taken by the Government as collateral to the note of the carrier. This note represented the cash advance normally required in financing an Equipment Trust (R., pp. 5-7, ff. 6-8).

Of course this financing might have taken the form of purchase of the deferred certificates by the Government instead of taking them as pledge.

If Congress had provided in Section 210 for preference under Section 3466 would its manifest purposes have been accomplished? Would it have enabled the carrier in the instant case to serve the public during the transition period? Would it have afforded assurance to those who were expected to extend credit for labor, material, supplies, operating expenses, etc, Or would they have refused to extend such credit and thus have prevented the carrier from

properly serving the public during the transition period?

But the Government took its own security for all these obligations involved in this litigation by large pledges of the refunding and extension bonds of the carrier. The Government thereby placed itself on a par with the private bondholder, at least as to security.

These bonds became an indebtedness to the Government. Suppose the Government were enforcing the obligation under these bonds, and upon foreclosure there was a deficiency. Could the Government as holder of these bonds have come into this proceeding and claimed priority for the deficiency over the private bondholder?

The court has already held in this proceeding what nobody, not even the Government, now questions, that the interest paid on these obligations to the Government during the six months prior to receivership constitutes a diversion as against the priority creditors.

Manifestly, *no different purpose as to governmental priority runs from section to section* in the Transportation Act, and the Transportation Act is tied up with the prior Feder Control legislation so that it is inconceivable that there should have been *a change of purpose from one Act to the other without congressional mention of it.*

Conceivably, the Government investment in railroad securities could equal and even exceed the stupendous sum of $1,750,000,000.

We think it is pertinent to suggest what might have been the result to railroad securities in the great exchanges of the country and to the extension of unsecured credit to railroads, even today, if the public press should suddenly announce that this court had determined that the Government had priority for all of these war debts. The

suggestion becomes more forceful if the Government's position here should be found to be correct and it should be held that the Government had such priority even over mortgages and other liens.

Indeed, if the Government's position is well taken, the priority *would extend to mortgages issued at the dictation of the President* during Federal Control.

In the light of the statutes and their broad purposes evidenced by their language, the circumstances and conditions under which they were enacted, the position of the Government is as though it should say this to its people:

"Your Government had to take over your public carriers for the war. We found it necessary to finance them so far as you didn't. We also paid the prior debts that matured and were liquidated and presented, all in order to reassure the business world in our country.

A vast debt arose in this manner from carriers to your Government, and we told you that we would hold this the same as a private holder. We did not otherwise specially mention priority.

When the war was over and your Government wished to cease Federal Control, we found that we could not do this without further Federal aid, because carrier credit was destroyed, the carriers were run down, transportation was in danger of breaking down, and a panic would have followed without such aid.

The Government wanted its people to extend credit to the carriers, current and funded, secured and unsecured.

To induce the people to do this, and to avoid these dire consequences which we feared, your Government undertook to fund for the carriers what its people would not fund of the vast debt incurred by carriers to your Government during the war and at our dictation. We made our

own terms for repayment, picked our own security for this debt which we had told you we would hold as a private holder, and to more effectually assure you that we meant to establish and maintain the carriers in condition to be worthy of private credit during the transition period following our control, your Government said it would make new loans to carriers for their essential needs on the unsalable security that the people would not and ought not to take.

In view of these considerations and these acts of your Government, we fully expected and invited you to extend credit to carriers as usual. Except as above stated, we made no special mention of priority, but we so worded our legislation and so stated our purpose as to lead you to believe that no priority was intended.

But now in view of the fact that the Government has failed in its broad purpose and a carrier has broken down in spite of all this and gone into receivership, your Government will step in ahead of you and take the assets for repayment, to the exclusion of what we asked and expected you to loan, and we even expect to displace all your liens, if any you have.

Your Government will do this, even as to those debts which we said we would hold privately, the same as our own people."

Notwithstanding the assertions of Government counsel that equitable considerations do not enter into the construction of these statutes as well as the circumstances under which Section 3466 shall apply we direct attention to the fact that in the authorities bearing on the question, cited in this brief, both the Federal Supreme Court and the subordinate courts have laid great stress upon such considerations. They have also stressed the question of

whether a particular construction or application will injuriously affect the general welfare of the people.

Congress did not intend governmental priority as to any of these debts.

The Decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted,

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APPENDIX.

I.

Federal Control Act of March 21, 1918.

Public Laws, 1917-1919, Vol. 40, Part 1, Page 451.

"An Act to Provide for the Operation of Transportation Systems While Under Federal Control, for the Just Compensation of Their Owners, and for Other Purposes."

Sec. 6. (*As amended March* 2, 1919.) That the sum of $500,000,000 is hereby appropriated, out of any moneys in the Treasury not otherwise appropriated, which, together with any funds available from any operating income of said carriers, may be used by the President as a revolving fund for the purpose of paying the expenses of the Federal Control, and so far as necessary the amount of just compensation, and to provide terminals, motive power, cars, and other necessary equipment, such terminals, motive power, cars, and equipment to be used and accounted for as the President may direct and to be disposed of as Congress may hereafter by law provide.

The President may also make or order any carrier to make any additions, betterments, or road extensions, and to provide terminals, motive power, cars, and other equipment necessary or desirable for war purposes or in the public interest on or in connection with the property of any carrier. He may from said revolving fund advance to such carrier all or any part of the expense of such additions, betterments, or road extensions, and to provide terminals, motive power, cars, and other necessary equipment so ordered and constructed by such carrier or by the President, such advances to be charged against such carrier and to bear interest at such rate and be payable on such terms as may be determined by the President, to the

end that the United States may be fully reimbursed for any sums so advanced.

Any loss claimed by any carrier by reason of any such additions, betterments, or road extensions so ordered and constructed may be determined by agreement between the President and such carrier; failing such agreement the amount of such loss shall be ascertained as provided in section three hereof * * *.

Sec. 7. That for the purpose of providing funds requisite for maturing obligations or for other legal and proper expenditures, or for reorganizing railroads in receivership, carriers may, during the period of Federal Control, issue such bonds, notes, equipment trust certificates, stock, and other forms of securities secured or unsecured by mortgage, as the President may first approve as consistent with the public interest. The President may, out of the revolving fund created by this Act, purchase for the United States all or any part of such securities at prices not exceeding par, and may sell such securities whenever in his judgment it is desirable at prices not less than the cost thereof. Any securities so purchased shall be held by the Secretary of the Treasury, who shall, under the direction of the President, represent the United States in all matters in connection therewith in the same manner as a private holder thereof. The President shall each year as soon as practicable after January first, cause a detailed report to be submitted to the Congress of all receipts and expenditures made under this section and section six during the preceding calendar year.

Sec. 8. That the President may execute any of the powers herein and heretofore granted him with relation to Federal Control through such agencies as he may determine * * *.

Sec. 10. That carriers while under Federal Control shall be subject to all laws and liabilities as common carriers, whether arising under State or Federal Laws or at common law, except insofar as may be inconsistent with the provisions of this Act or any other Act applicable to such Federal Control or with any order of the President. Actions at law or suits in equity may be brought by and against such carriers and judgments rendered as now provided by law; and in any action at law or suit in equity against the carrier, no defense shall be made thereto upon the ground that the carrier is an instrumentality or agency of the Federal Government. Nor shall any such carrier be entitled to have transferred to a Federal Court any action heretofore or hereafter instituted by or against it, which action was not so transferable prior to the Federal Control of such carrier; and any action which has heretofore been so transferred because of such Federal Control or of any Act of Congress or official order or proclamation relating thereto shall upon motion of either party be retransferred to the court in which it was originally instituted. But no process, mesne or final, shall be levied against any property under such Federal Control * * *.

Sec. 12. That moneys and other properties derived from the operation of the carriers during Federal Control are hereby declared to be the property of the United States. Unless otherwise directed by the President, such moneys shall not be covered into the Treasury but such moneys and property shall remain in the custody of the same officers, and the accounting thereof shall be in the same manner and form as before Federal Control. Disbursements therefrom shall, without further appropriation, be made in the same manner as before Federal Control and

for such purposes as under the Interstate Commerce Commission classification of accounts in force on December twenty-seventh, nineteen hundred and seventeen, are chargeable to operating expenses or to railway tax accruals and for such other purposes in connection with Federal Control as the President may direct, except that taxes under Titles One and Two of the Act entitled "an Act to provide revenue to defray war expenses, and for other purposes," approved October third, nineteen hundred and seventeen, or any Act in addition thereto or in amendment thereof, shall be paid by the carrier out of its own funds. If Federal Control begins or ends during the tax year for which any taxes so chargeable to railway tax accruals are assessed, the taxes for such year shall be apportioned to the date of the beginning or ending of such Federal Control, and disbursements shall be made only for that portion of such taxes as is due for the part of such tax year which falls within the period of Federal Control.

At such periods as the President may direct, the books shall be closed and the balance of revenues over disbursements shall be covered into the Treasury of the United States to the credit of the revolving fund created by this Act. If such revenues are insufficient to meet such disbursements, the deficit shall be paid out of such revolving fund in such manner as the President may direct * * *.

Sec. 14. That the Federal Control of railroads and transportation systems herein and heretofore provided for shall continue for and during the period of the war and for a reasonable time thereafter, which shall not exceed one year and nine months next following the date of the proclamation by the President of the exchange of ratifications of the treaty of peace:

Provided however * * * the President may relinquish all railroads and systems of transportation under Federal Control at any time he should deem such action needful or desirable * * *.

Sec. 15. That nothing in this Act shall be construed to amend, repeal, impair, or affect the existing laws or powers of the States in relation to taxation or the lawful police regulations of the several States, except wherein such laws, powers, or regulations may affect the transportation of troops, war materials, Government supplies, or the issue of stocks and bonds.

Sec. 16. That this Act is expressly declared to be emergency legislation enacted to meet conditions growing out of war; and nothing herein is to be construed as expressing or prejudicing the future policy of the Federal Government concerning the ownership, control, or regulation of the carriers or the method or basis of the capitalization thereof.

II.

Act of November 19, 1919.

Public Laws, 1919-1921, Vol. 41, Part 1, Page 359.

AN ACT To provide for the reimbursement of the United States for motive power, cars, and other equipment ordered for railroads and systems of transportation under Federal Control, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That in order to make provision for the reimbursement of the United States for the sums advanced to provide motive power, cars, and other equipment ordered

by the President for the railroads and systems of transportation now under Federal Control, herein called "carriers," pursuant to the authority conferred by the second paragraph of section 6 of the Act of March 21, 1918, the President may, upon such terms as he shall deem advisable, receive in reimbursement cash, or obligations of any carrier, or part cash and part such obligations, or in his discretion he may accept for such motive power, cars, or other equipment, cash or the shares of stock or obligations, secured or unsecured, of any corporation not a carrier organized for the purpose of owning equipment or equipment obligations, or part cash and part such shares of stock and obligations, and he may transfer to such corporation any obligations of carriers received on account of motive power, cars, or other equipment, and he may execute any instruments necessary and proper to carry out the intent of the second paragraph of section 6 of said Act of March 21, 1918, to the end that title to the motive power, cars, and other equipment so ordered by the President as aforesaid for the carriers may rest in them or their trustees or nominees.

In addition to the powers herein and heretofore conferred, the President is further authorized to dispose, in the manner and for the consideration aforesaid, of motive power, cars, and other equipment, if any, provided by him in accordance with any other provisions of said section, and of any obligations of carriers that may be received in reimbursement of the cost thereof * * *.

Sec. 3. That nothing herein contained shall be deemed to abrogate or limit the powers conferred upon the President by said Act of March 21, 1918.

Sec. 4. That the President may execute any of the powers herein granted through such agencies as he may determine.

Sec. 5. That this Act is emergency legislation, enacted to meet conditions growing out of war and to effectuate said Act of March 21, 1918.

III.

The Transportation Act of February 28, 1920.

Chap. 91, Vol. 41, Stat. L. Page 456.

"An Act to Provide for the Termination of Federal Control of Railroads and Systems of Transportation, etc."

Sec. 202. The President shall, as soon as practicable after the termination of Federal Control, adjust, settle, liquidate and wind up all matters, including compensation, and all questions and disputes of whatsoever nature, arising out of or incident to Federal Control. For these purposes and for the purpose of making the payments specified in subdivision (a) of section 201, all unexpended balances in the revolving fund created by the Federal Control Act or of the moneys appropriated by the Act entitled "An Act to supply a deficiency in the appropriation for carrying out the Act entitled 'An Act to provide for the operation of transportation systems while under Federal Control, for the just compensation of their owners, and for other purposes,' approved March 21, 1918," approved June 30, 1919, are hereby reappropriated and made available until expended; and all moneys derived from the operation of the carriers or otherwise arising out of Federal Control, and all moneys that have been or may be received in payment of the indebtedness of any carrier to the United States arising out of Federal Control, shall be and re-

main available until expended for the aforesaid purposes; and there is hereby appropriated for the aforesaid purposes, out of any money in the Treasury not otherwise appropriated, $200,000,000 in addition to the above, to be available until expended.

Sec. 207. (a) As soon as practicable after the termination of Federal Control the President shall ascertain (1) the amount of the indebtedness of each carrier to the United States, which may exist at the termination of Federal Control, incurred for additions and betterments made during Federal Control and properly chargeable to capital account; (2) the amount of indebtedness of such carrier to the United States otherwise incurred; and (3) the amount of the indebtedness of the United States to such carrier arising out of Federal Control. The amount under clause (3) may be set off against either or both of the amounts under clauses (1) and (2), so far as deemed wise by the President, but only to the extent permitted under any contract now or hereafter made between such carrier and the United States in respect to the matters of Federal Control, or, where no such contract exists, to the extent permitted under paragraph (b) of section 7 of the standard contract between the United States and the carriers relative to deductions from compensation: *Provided,* That such right of set-off shall not be so exercised as to prevent such carrier from having the sums required for interest taxes, and other corporate charges and expenses referred to in paragraph (b) of section 7 of such standard contract, accruing during Federal Control and also the sums required for dividends declared and paid during Federal Control, including, also in addition, a sum equal to that proportion of such last dividend which the period be-

tween its payment and the termination of Federal Control bears to the last regular dividend period: *And provided further,* That such right of set-off shall not be exercised unless there shall have first been paid such sums in addition as may be necessary to provide the carrier with working capital in amount not less than one twenty-fourth of its operating expenses for the calendar year 1919.

(b) Any remaining indebtedness of the carrier to the United States in respect to such additions and betterments shall, at the request of the carrier, be funded for a period of ten years from the termination of Federal Control, or a shorter period at the option of the carrier, with interest at the rate of 6 per centum per annum, payable semi-annually, subject to the right of such carrier to pay, on any interest-payment day, the whole or any part of such indebtedness. Any carrier obtaining the funding of such indebtedness as aforesaid shall give, in the discretion of the President, such security, in such form and upon such terms, as he may prescribe.

(c) If the President and the various carriers, or any of them, shall enter into an agreement for funding, through the medium of car trust certificates, or otherwise, the indebtedness of any such carrier to the United States incurred for equipment ordered for the benefit of such carrier, such indebtedness so funded shall not be refundable under the foregoing provisions.

(d) Any other indebtedness of any such carrier to the United States which may exist after the settlement of accounts between the United States and the carrier and is then due shall be evidenced by notes payable in one year from the termination of Federal Control, or a shorter period at the option of the carrier, with interest at the rate

of 6 per centum per annum, and secured by such collateral security as the President may deem it advisable to require.

(e) With respect to any bonds, notes, or other securities, acquired under the provisions of this section or of the Federal Control Act or of the Act entitled "An Act to provide for the reimbursement of the United States for motive power, cars and other equipment ordered for railroads and systems of transportation under Federal Control, and for other purposes," approved November 19, 1919, the President shall have the right to make such arrangements for extension of the time of payment or for the exchange of any of them for other securities, or partly for cash and partly for securities, as may be provided for in any agreement entered into by him or as may in his judgment seem desirable.

(f) Carriers may, by agreement with the President, issue notes or other evidences of indebtedness, secured by equipment trust agreements, for equipment purchased during Federal Control by or through the President under section 6 of the Federal Control Act, and allocated to such carriers respectively; and the filing of such equipment trust agreements with the Commission shall constitute notice thereof to all the world.

(g) A carrier may issue evidences of indebtedness pursuant to this section without the authorizing or approval of any authority, State or Federal, and without compliance with any requirement, State or Federal, as to notification * * *.

Sec. 209: This Section covers method of determining just compensation to carriers for Government use during

the war both those with and without contracts, provides for a guaranty period as a basis for such determination and contains this provision.

(h) Upon application of any carrier to the Commission, asking that during the guaranty period there may be adanced to it from time to time such sums, not in excess of the estimated amount necessary to make good the guaranty, as are necessary to enable it to meet its fixed charges and operating expenses, the Commission may certify to the Secretary of the Treasury the amount of, and times at which, such advances, if any, shall be made. The Secretary of the Treasury, on receipt of such certificate, is authorized and directed to make the advances in the amounts and at the times specified in the certificate, upon the execution by the carrier of a contract, secured in such manner as the Secretary may determine, that upon final determination of the amount of the guaranty provided for by this section such carrier will repay to the United States any amounts which it has received from such advances in excess of the guaranty, with interest at the rate of 6 per centum per annum from the time such excess was paid. There is hereby appropriated, out of any money in the Treasury not otherwise appropriated, a sum sufficient to enable the Secretary of the Treasury to make the advances referred to in this subdivision * * *.

Sec. 210. (*As amended June* 5, 1920.) (a) For the purpose of enabling carriers by railroad subject to the Interstate Commerce Act properly to serve the public during the transition period immediately following the termination of Federal Control, any such carrier may, at any time after the passage of this Act, and before the expiration of two years after the termination of Federal Control

make application to the Commission for a loan from the United States to meet its maturing indebtedness or to provide itself with equipment or other additions and betterments, setting forth the amount of the loan; the term for which it is desired; the purpose of the loan and the use to which it will be applied; the present and prospective ability of the applicant to repay the loan and meet the requirements of its obligations in that regard; the character and value of the security offered; and the extent to which the public convenience and necessity will be served. The application shall be accompanied by statements showing such facts in detail as the Commission may require with respect to the physical situation, ownership, capitalization, indebtedness, contract obligations, operation, and earning power of the applicant, together with such other facts relating to the propriety and expediency of granting the loan applied for, and the ability of the applicant to make good the obligation as the Commission may deem pertinent to the inquiry.

(b) If the Commission, after such hearing and investigation, with or without notice, as it may direct, finds that the making, in whole or in part, of the proposed loan by the United States, for one or more of the aforesaid purposes, is necessary to enable the applicant properly to meet the transportation needs of the public, and that the prospective earning power of the applicant and the character and value of the security offered are such as to furnish reasonable assurance of the applicant's ability to repay the loan within the time fixed therefor, and to meet its other obligations in connection with such loan the Commission shall certify to the Secretary of the Treasury its findings of such facts; also the amount of the loan which is to

be made; the time, not exceeding fifteen years from the making thereof, within which it is to be repaid; the terms and conditions of the loan, including the security to be given for repayment; that the prospective earning power of the applicant, together with the character and value of the security offered, furnish in the opinion of the Commission, reasonable assurance of the applicant's ability to repay the loan within the time fixed therefor and reasonable protection to the United States; and that the applicant, in the opinion of the Commission, is unable to provide itself with the funds necessary for the aforesaid purposes from other sources.

(c) Upon receipt of such certificate from the Commission the Secretary of the Treasury shall immediately, or as soon as practicable, make a loan of the amount recommended in such certificate out of any funds in the revolving fund provided for in this section and accept the security prescribed therefor by the Commission. All such loans shall bear interest at the rate of 6 per centum per annum, payable semi-annually, to the Secretary of the Treasury, and to be placed to the credit of said revolving fund. The form of obligation to be entered into shall be prescribed by the Secretary of the Treasury, but the time, not exceeding fifteen years from the making thereof, within which such loan is to be repaid. The security which is to be taken therefor and the terms and the conditions of the loan shall be in accordance with the findings and the certificate of the Commission.

(d) The Commission or the Secretary of the Treasury may call upon the Federal Reserve Board for advice and assistance with respect to any such application or loan.

(e) There is hereby appropriated out of any moneys in the Treasury not otherwise appropriated the sum of $300,000,000, which shall be used as a revolving fund for the purpose of making the loans provided for in this section, and for paying the judgments, decrees, and awards referred to in subdivision (e) of section 206.

(f) A carrier may issue evidences of indebtedness to the United States pursuant to this section without the authorization or approval of any authority, State or Federal, and without compliance with any requirement, State or Federal, as to notification.

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DEC 31

CHARLES ELMORE

Supreme Court of the United States

October Term, 1929.

No. 402.

UNITED STATES OF AMERICA,

Petitioner,

vs.

GUARANTY TRUST COMPANY OF NEW YORK, et al,

Respondents.

Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

BRIEF FOR MORTGAGE TRUSTEES, RESPONDENTS.

EDWIN S. S. SUNDERLAND,
WARREN S. CARTER,
Solicitors for Guaranty Trust Company of New York,
Respondent.

HENRY V. POOR,
FREDERICK G. INGERSOLL,
Solicitors for Central Hanover Bank & Trust Company (formerly Central Union Trust Company),
Respondent.

JOSEPH M. HARTFIELD,
JESSE E. WAID,
NORTON M. CROSS,
KENNETH TAYLOR,
Solicitors for New York Trust Company,
Respondent.

JAMES H. McINTOSH,
CHARLES BUNN,
Solicitors for Bankers Trust Company,
Respondent.

EDWARD H. BLANC,
JAMES C. OTIS,
Solicitors for City Bank Farmers Trust Company (formerly The Farmers Loan and Trust Company),
Respondent.

INDEX.

	Page.
Opinions below	1
The Question	2
Statement	2
Summary of Argument	3
Argument	4
Appendix I—Statute dealing with Government Priority	11
Appendix II—	
(1) Decisions of inferior Federal Courts	17
(2) Opinions of the Attorney General	19
(3) Other authorities	20

TABLE OF CASES.

	Page.
Brent v. Bank of Washington, 10 Peters 596	7
Case of Jacob Richardson, 90 Op. Atty. Gen. 28	20
Conard v. Atlantic Insurance Co., 1 Peters 386	5
Cottrell v. Pierson, 12 Fed. 805	19
Discharge of Insolvent Debtors, 5 Op. Atty. Gen. 762	19
Field v. United States, 9 Peters 182	7
Priority of United States over Creditors, 1 Op. Atty. Gen. 616	19
Savings & Loan Society v. Multnomah County, 169 U. S. 421	7
Spokane County v. United States, 279 U. S. 80	8
Thelusson v. Smith, 2 Wheaton 396	5

United States v. Canal Bank, Fed. Cas. 14,715 18
United States v. Cutts, Fed. Cas. 14,912 17
United States v. Delaware Insurance Co., Fed. Cas. 14,942. 17
United States v. Duncan, Fed. Cas. 15,003 18
United States v. Fisher, 2 Cranch 385 4
United States v. Hooe, 3 Cranch 73 4
United States v. Lewis, Fed. Cas. 15,595 18
United States v. Oklahoma, 261 U. S. 253 8
United States v. Sheriff of Charleston, Fed. Cas. 16,276.. 17

STATUTES.

1 Stat. 169 11
1 Stat. 263 11
1 Stat. 515 13
1 Stat. 676 13
Rev. Stats. Sec. 3466 16
U. S. Code Tit. 31, Sec. 191 16

OTHER AUTHORITIES.

39 Harvard Law Review 1 20
43 Harvard Law Review 253 20

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Certiorari to the United States Circuit Court of Appeals for the Eighth Circuit.

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OPINIONS BELOW.

The opinion of the Special Master is at R. 17. The District Court concurred in the conclusions of the Master without additional discussion (R. 72). The opinion of the Circuit Court of Appeals (R. 81) is reported at 33 Fed. (2nd) 533.

THE QUESTION.

Priority is here claimed for the United States not only over general creditors and against unmortgaged property, but over the holders of mortgage bonds as to property mortgaged many years before the claims of the United States arose. The only question which we shall discuss is whether the priority of the United States (if it has any priority) displaces such prior mortgage liens.

STATEMENT.

The seven mortgages whose liens are sought to be displaced were made by five different railroad corporations ("Minneapolis Company No. 1", "Minneapolis Company No. 3", "Minneapolis Company No. 4", Iowa Central Railway Company, Des Moines & Fort Dodge Railroad Company). (R. 10-13.) The earliest bears date February 1, 1877, the latest January 1, 1912. Each was executed on or about the date it bears, and thereupon duly recorded. Bonds were issued and are outstanding under each in large amounts (R. 10-13). In 1916 "Minneapolis Company No. 5" was created and acquired the several properties subject to the mortgages (R. 13). In 1918 this corporation was operated under federal control (R. 13), and then and thereafter it became indebted to the United States in the various amounts stated in the record (R. 4-10). This is also the corporation which is in receivership (R. 13). The Court will notice that it never owned any of the properties except subject to the mortgages; and also that the youngest mortgage preceded by nine years the oldest debt to the United States, and preceded by eleven years the insolvency and receivership which created the Government's priority.

Certain Refunding and Extension mortgage bonds (being bonds issued under the mortgage of 1912, of which Guaranty Trust Company of New York is Trustee) are held by the United States in pledge to secure certain parts of the indebtedness (R. 7). The rights of the United States as pledgee of these bonds are not disputed.

SUMMARY OF ARGUMENT.

It has been decided by this Court that the priority of the United States is subordinate to mortgage liens existing lawfully before the insolvency arises. Here the liens precede not only the insolvency but the debts to the United States themselves. The decisions of this Court are definite that such liens are not to be displaced.

ARGUMENT.

The United States have no common law priority as sovereign. The priority they claim depends entirely on Rev. Stat., Sec. 3466 (now U. S. Code, Title 31, Sec. 191). This act has been in force in substantially its present form since 1797. (The statutes, from the 1st Congress to the U. S. Code, are set out in Appendix I.) Its effect is therefore now a matter of authority. It will be convenient to refer, in their chronological order, to the decisions of this Court.

In *United States v. Fisher,* 2 Cranch 358 (1804), the Court said by Chief Justice Marshall:

> "On this subject it is to be remarked that no lien is created by this law. No bona fide transfer of property in the ordinary course of business is overreached."

The point now raised was not presented by the case.

United States v. Hooe, 3 Cranch 73 (1805). In this case F, a collector of customs, being largely in arrears in his accounts with the United States, made a deed of trust of his lands to indemnify Hooe, the surety on his official bond, against that liability and liability to be assumed as endorser of F's notes. Hooe knew about F's debt to the Government at the time the deed was made. F died. Lands conveyed under the trust deed were sold by the trustees, and the question was between Hooe and the United States as to the disposition of the proceeds. The decision was in favor of Hooe. The Court said by Chief Justice Marshall:

> "In construing the statutes on this subject, it has been stated by the court, on great deliberation, that the priority to which the United States are entitled does not partake of

the character of a lien on the property of public debtors. This distinction is always to be recollected.

* * * * *

"If a debtor of the United States, who makes a bona fide conveyance of part of his property for the security of a creditor, is within the act which gives a preference to the government, then would that preference be in the nature of a lien from the instant he became indebted; the inconvenience of which, where the debtor continued to transact business with the world, would certainly be very great."

Thelusson v. Smith, 2 Wheaton 396 (1817). In this case plaintiffs had a judgment against Crammond May 20, 1805. Two days later he made a general assignment for the benefit of creditors. The United States then recovered judgments against him, and certain of his lands were sold on execution on those judgments. The plaintiffs claimed the proceeds of those sales, asserting that their judgments were a prior lien. They had done nothing to execute their judgments. The Court held that the general floating lien of their judgments was postponed to the executed sale by the United States. The Court, however, said:

"The United States are to be first satisfied; but then it must be out of the debtor's estate. If, therefore, before the right of preference has accrued to the United States, the debtor has made a bona fide conveyance of his estate to a third person, or has mortgaged the same to secure a debt, or if his property has been seized under a *fi. fa.*, the property is divested out of the debtor, and cannot be made liable to the United States."

Conard v. Atlantic Insurance Co., 1 Peters 386 (1828). In this case the conflict was between the Insurance Company, a creditor secured by respondentia bond, and the United States as judgment and execution creditor. The decision was in

favor of the private creditor. The nature of the Government's priority was discussed at length by Mr. Justice Story. He said:

"Then, again, it is contended on behalf of the United States that the priority thus created by law, if it be not of itself a lien, is still superior to any lien, and even to an actual mortgage, on the personal property of the debtor.

"It is admitted that where any absolute conveyance is made, the property passes so as to defeat the priority, but it is said that a lien has been decided to have no such effect; and that, in the eye of a court of equity, a mortgage is but a lien for a debt. *Thelluson v. Smith,* 2 W. 396, has been mainly relied on in support of this doctrine. That case has been greatly misunderstood at the bar, and will require a particular explanation. But the language of the learned Judge who delivered the opinion of the court in that case is conclusive on the point of a mortgage: 'The United States,' said he, 'are to be first satisfied; but then it must be out of the debtor's estate. If, therefore, before the right of preference has accrued to the United States, the debtor has made a bona fide conveyance of his estate to a third person, or has mortgaged the same to secure a debt; or if his property has been seized under a *fieri facias,* the property is divested out of the debtor, and cannot be made liable to the United States.' The same doctrine may be deduced from the case of *United States v. Fisher,* 2 C. 358, where the court declared that 'no bona fide transfer of property in the ordinary course of business, is overreached by the statutes'; and 'that a mortgage is a conveyance of property, and passes it conditionally to the mortgagee'. If so plain a proposition required any authority to support it, it is clearly maintained in *United States v. Hooe,* 3 C. 73.

* * * * *

But it has never yet been decided, by this court, that the priority of the United States will divest a specific lien, attached to a thing, whether it be accompanied by possession or not. * * * And before such decision is made, it will deserve very grave deliberation, and a marked atten-

tion to what fell from the court, in *Nathan v. Giles,* 5 Taunt. 558, 574. At present it is wholly unnecessary to decide it, for reasons which will hereafter appear."

Field v. United States, 9 Peters 182 (1835). This was a suit by the United States against the "syndics" (assignees) of an insolvent debtor. The assignees had sold the debtor's property, and distributed a portion of the proceeds. Some of the property was subject to mortgages. The Court said by Chief Justice Marshall:

> "There is no doubt that the mortgages upon particular estates sold, must be first paid out of the proceeds of the sales of those estates."

Brent v. Bank of Washington, 10 Peters 596 (1836). In this case Robert Brent, a stockholder of the Bank of Washington, died insolvent, indebted both to the bank and to the United States. The charter of the bank gave it a lien on its shares by prohibiting their transfer until debts due the bank were paid. The suit was to enforce a transfer of the shares, for the benefit of the United States, without satisfaction of the claims due to the bank. This Court held for the bank, and said:

> "This preference is in the appropriation of the debtor's estate; so that if, before it has attached, the debtor has conveyed or mortgaged his property, or it has been transferred in the ordinary course of business, neither are overreached by the statutes, 1 Pet. 440; and it has never been decided that it affects any lien, general or specific, existing when the event took place which gave the United States a claim of priority."

In *Savings and Loan Society v. Multnomah County,* 169 U. S. 421, the court held that a mortgage was an interest in real estate and taxable at the situs of the land. In that connection it was said:

> "This court has always held that a mortgage of real estate, made in good faith by a debtor to secure a private debt, is a conveyance of such an interest in the land, as will defeat the priority given to the United States by act of Congress in the distribution of the debtor's estate. *United States v. Hooe,* 3 Cranch 73; *Thelusson v. Smith,* 2 Wheat. 396, 426; *Conard v. Atlantic Ins. Co.,* 1 Pet. 386, 441."

In *United States v. Oklahoma,* 261 U. S. 253, at 259, the Court said:

> "The claim of the United States to the asserted priority rests exclusively upon the statute. No lien is created by it. It does not overreach or supersede any bona fide transfer of property in the ordinary course of business. It establishes priority which is limited to the particular state of things specified."

In *Spokane County v. United States,* 279 U. S. 80, the conflict was between United States and State taxes. The Supreme Court of Washington had held that what it described as the "inchoate tax lien right" of the State had never been perfected so as to be a lien on specific property. This Court therefore said:

> "Whatever might have been the effect of more completed procedure in the perfecting of the liens under the law of the state, upon the priority of the United States herein, the attitude of the state court relieves us of consideration of it."

We attach to this brief, as appendix II, reference to the decisions of the inferior Federal Courts, and to certain opinions of the Attorney General.

It is suggested that some or all of the foregoing statements are mere dictum. It may be admitted that in certain of the cases other grounds were present for decision, and were relied on by the Court. But the Court also regarded as important

the principles announced in the foregoing quotations. And it is impossible to be mistaken as to the course of the decisions. In every single case where a private creditor appeared holding a specific lien antedating the insolvency, the decision was in favor of the private creditor. All kinds of liens have been considered and all attaching to specific property have been protected. The principle that private lenders may safely make advances on usual securities without seeing those securities displaced by general obligations to the government, has become a rule of property, on which vast sums have been advanced to all kinds of business corporations.

Many of the cases were much stronger for the Government than this. In the *Hooe* case, for instance, the debt to the Government existed and was known to the private creditor when the security was given. In this case the debtor of the Government did not even own the property (indeed was not even in existence) when the mortgages were made.

It is suggested that the Government's advances saved the property in 1921 and thereby benefited mortgagees. That suggestion would no doubt be important if the property and liens were maritime. But on land the prior mortgagee is prior until he himself consents to subordinate his mortgage, or until a court of equity, conducting a receivership, orders the creation of a superior lien. These loans and obligations to the United States were created not by the mortgagees or with their participation, nor by any court, but by arrangements between the debtor and the Government alone. It is not possible by such an arrangement, however proper and wise for both the parties to it, to divest third persons of their existing security. Nor is it clear that benefit to the mortgagees exists. No doubt the Government advances were of assistance to the railroad company, and postponed its receivership and default on its mortgages. But it is by no means clear that the holder of a mort-

gage on a failing enterprise is benefited by postponement of the date on which he is permitted to foreclose.

Respectfully submitted,

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APPENDIX I.

The following are the acts, from the beginning of the Government, dealing with the subject now covered by Revised Statutes, Section 3466.

I.

First Congress, Sess. II, Chap. 35, approved August 4, 1790, I Statutes at Large, 169:

"An Act to provide more effectually for the collection of duties imposed by law on goods, wares and merchandise imported into the United States, and on the tonnage of ships or vessels.

* * * * *

Section 45. And be it further enacted, that where any bond for the payment of duties shall not be satisfied on the day it became due, the collector shall forthwith cause a prosecution to be commenced for the recovery of the money thereon, by action or suit at law, in the proper court having cognizance thereof; and in all cases of insolvency, or where any estate in the hands of executors or administrators shall be insufficient to pay all the debts due from the deceased, the debt due to the United States, on any such bond, shall be first satisfied."

II.

Second Congress, Sess. I, Ch. 27, approved May 2, 1792, I Statutes at Large 263.

"An act for raising a further sum of money for the protection of the frontiers, and for other purposes therein mentioned."

* * * * *

Section 18. "AND BE IT ENACTED AND DECLARED, That if the principal in any bond which shall be given to the United States, for duties on goods, wares, and merchandise imported, shall be insolvent, or if such principal being dead, his or her estate and effects, which shall have come to the hands of his or her executors or administrators, shall be insufficient for the payment of his or her debts, and if, in either of the said cases, any surety in any said bond, or the executors and administrators of such surety, shall pay to the United States the monies thereupon due, such surety, his or her executors or administrators, shall have and enjoy the like advantage, priority and preference, for the recovery and receipt of the said monies out of the estate and effects of such insolvent or deceased principal, as are reserved and secured to the United States, by the forty-fourth (should be the 45th) section of the Act, entitled 'An Act to provide more effectually for the collection of duties imposed by law on goods, wares and merchandise imported into the United States, and on the tonnage of ships or vessels', and shall and may bring and maintain a suit upon the said bond, in law or equity, in his, her or their own name or names, for the recovery of the monies which shall have been paid thereupon. AND IT IS FURTHER DECLARED, that the cases of insolvency in the said forty-fourth section mentioned, shall be deemed to extend as well to cases in which a debtor, not having sufficient property to pay all his or her debts, shall have made a voluntary assignment thereof, for the benefit of his or her creditors, or in which the estate and effects of an absconding, concealed or absent debtor shall have been attached by process of law, as to cases, in which an act of legal bankruptcy shall have been committed."

III.

Fourth Congress, Session II, Chapter 20, approved March 3, 1797, I Statutes at Large, 515:

"An Act to provide more effectually for the settlement of accounts between the United States and receivers of public money.

* * * * *

Section 5. And be it further enacted, that where any revenue officer, or other person hereafter becoming indebted to the United States, by bond or otherwise, shall become insolvent, or where the estate of any deceased debtor, in the hands of executors or administrators, shall be insufficient to pay all the debts due from the deceased, the debt due to the United States shall be first satisfied; and the priority hereby established shall be deemed to extend, as well to cases in which a debtotr, not having sufficient property to pay all his debts, shall make a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor, shall be attached by process of law, as to cases in which an act of legal bankruptcy shall be committed."

IV.

Fifth Congress, Sess. III, Ch. 22, approved March 2, 1799, I Statutes at Large p. 676.

"An Act to regulate the collection of duties on imports and tonnage."

* * * * *

Section 65. "And Be It Further Enacted, That where any bond for the payment of duties shall not be satisfied on the day it may become due, the collector shall, forthwith and without delay, cause a prosecution to be commenced for the recovery of the money thereon by action or suit at law, in the proper court having cognizance thereof; and in all cases of insolvency, or where any estate in the

hands of the executors, administrators or assignees, shall be insufficient to pay all the debts due from the deceased, the debt or debts due to the United States, on any such bond or bonds, shall be first satisfied; and any executor, administrator, or assignees, or other person, who shall pay any debt due by the person or estate from whom, or for which, they are acting, previous to the debt or debts due to the United States from such person or estate being first duly satisfied and paid, shall become answerable in their own person and estate, for the debt or debts so due to the United States, or so much thereof as may remain due and unpaid; and actions or suits at law may be commenced against them for the recovery of the said debt or debts, or so much thereof as may remain due and unpaid, in the proper court having cognizance thereof; PROVIDED, that in all cases in which suits or prosecutions shall be commenced for the recovery of duties or pecuniary penalties prescribed by the laws of the United States, the person or persons against whom process may be issued, shall and may be held to special bail, subject to the rules and regulations which prevail in civil suits in which special bail is required: AND PROVIDED ALSO, that if the principal in any bond, which shall be given to the United States for duties on goods, wares or merchandise imported, or other penalty, either by himself his factor, agent, or other person for him, shall be insolvent, or if such principal being deceased, his, or her estate and effects, which shall come to the hands of his or her executors, administrators or assignees, shall be insufficient for the payment of his or her debts, and if in either of the said cases, any surety on the said bond or bonds, or the executors, administrators or assignees of such surety shall pay to the United States the money due upon such bond or bonds, such surety, his or her executors, administrators or assignees, shall have and enjoy the like advantage, priority or preference for the recovery and receipt of the said monies out of the estate and effects of such insolvent, or deceased principal, as are reserved and se-

cured to the United States; and shall and may bring and maintain a suit or suits upon the said bond or bonds in law or equity, in his, her, or their own name or names, for the recovery of all monies paid thereon. And the cases of insolvency mentioned in this section, shall be deemed to extend as well to cases in which a debtor, not having sufficient property to pay all his or her debts, shall have made a voluntary assignment thereof, for the benefit of his or her creditors, or in which the estate and effects of an absconding, concealed or absent debtor, shall have been attached by process of law, as to cases in which an act of legal bankruptcy shall have been committed. And where suit shall be instituted on any bond for the recovery of duties due to the United States, it shall be the duty of the court, where the same may be pending, to grant judgment at the return term, on motion, unless the defendant shall, in open court, the United States Attorney being present, make oath or affirmation that an error has been committed in the liquidation of the duties demanded upon such bond, specifying the errors alleged to have been committed, and that the same have been notified in writing to the Collector of the district, prior to the commencement of the return term aforesaid: whereupon, if the court be satisfied, that a continuance until the next succeeding term, is necessary for the attainment of justice, and not otherwise, a continuance may be granted until next succeeding term and no longer. And on all bonds upon which suits shall be commenced, an interest shall be allowed at the rate of six per cent per annum, from the time when said bonds become due, until the payment thereof."

V.

Revised Statutes, 1873-4.

Title XXXVI. Debts Due By Or To the United States.

Section 3466. "Whenever any person indebted to the United States is insolvent, or whenever the estate of any deceased debtor, in the hands of the executors or administrators, is insufficient to pay all the debts due from the deceased, the debts due to the United States shall be first satisfied; and the priority hereby established shall extend as well to cases in which a debtor, not having sufficient property to pay all his debts, makes a voluntary assignment thereof, or in which the estate and effects of an absconding, concealed, or absent debtor are attached by process of law, as to cases in which an act of bankruptcy is committed."

VI.

United States Code, Title 31, Section 191.

(This is identical with Revised Statutes, Section 3466.)

APPENDIX II.

DECISIONS OF INFERIOR FEDERAL COURTS, AND OPINIONS OF THE ATTORNEY GENERAL.

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(1) *Inferior Federal Courts.*

In *United States v. Sheriff of Charleston*, Fed. Cas No. 16,276 (1803), the United States and a private person each had judgment against the collector of the port and levied execution on the same property. The private judgment and levy were first in time. The suit was to enjoin a sale under the private levy. The Court sustained a demurrer to the bill and said:

> "I cannot find that these acts do in any manner comprehend the present case. There is not a syllable in either of them that can be fairly construed to divest a prior legal lien."

In *United States v. Delaware Insurance Co.*, Fed. Case No. 14,942 (1823), the defendant loaned money to a merchant in the China trade, secured by respondentia and bills of lading. The merchant failed, being indebted to the United States for customs duties, and the controversy was as to the proceeds of the goods covered by the bills of lading. Mr. Justice Washington directed a verdict for defendant.

In *United States v. Cutts*, Fed. Case No. 14,912 (1832), an insolvent decedent had before his death endorsed to and pledged with a lender, as security, certain five per cent stock of the United States. The transfer of the stock had never been recorded on the public books. Mr. Justice Story stated the question to be:

> "Whether the instrument under which Schaefe claims a right to the stock in controversy, and the deposit of the certificate with him, were a sufficient equitable assignment of the stock, or gave a sufficient lien thereon to defeat the priority of the United States,"

and decided that they did.

In *United States v. Canal Bank*, Fed. Case No. 14,715 (1844), the United States and a private creditor had both recovered judgments against the same debtor, and had levied attachments on the same property. The attachment of the private creditor was first in time. Mr. Justice Story held it superior to that of the United States.

In *United States v. Duncan*, Fed. Case No. 15,003 (1850), the Court said:

> "It has been uniformly held in all the cases that the priority of the United States does not disturb any specific lien, nor the perfected lien of a judgment, that is it does not supersede a mortgage on land, nor a judgment made perfect by the issue of an execution and a levy on land. *Thelluson v. Smith*, 2 Wheat. (15 U. S.) 396; *Conard v. Atlantic Ins. Co.*, 1 Pet. (26 U. S.) 386."

In *United States v. Lewis*, Fed. Case No. 15,595 (1875), the Court said (by Mr. Justice Strong):

> "True, the priority of the United States does not override any liens upon the debtor's property which existed before the event occurred which gives the statutory priority, that is, before the insolvency. *Conard v. Atlantic Ins. Co.*, 1 Pet (26 U. S.) 438; *Brent v. Bank of Washington*, 10 Pet. (35 U. S.) 596. The reason for this is obvious. The claim of the government extends only to that which was the property of the debtor when he became insolvent, and his property is only that, in substance, which remains

after the satisfaction of liens upon it. His power of disposition extends no farther. The lien is paramount to his right."

In *Cottrell v. Pierson,* 12 Fed. 805 (1881), the Court said:

"It may now be regarded as settled that the priority of the United States, given by these statutes, 'does not overrule any liens upon the debtor's property which existed befor the event occurred which gives the statutory priority; that is, before the insolvency.' *U. S. v. Lewis,* 13 N. B. R. 38; *Conard v. Ins. Co.,* 1 Pet. 438; *Brent v. The Bank,* 10 Pet. 596."

(2) *Opinions of the Attorney General.*

Priority of United States over other Creditors, 1 Op. Atty. Gen. 616 (1823). In this opinion the Attorney General (Wm. Wirt) advised that a lien on an insurance policy for a premium advanced was not preferred over a debt to the United States. The opinion proceeds on two grounds: (1) The authority of Thelluson v. Smith; (2) the fact that the private creditor had voluntarily parted with possession of the policy.

Discharge of Insolvent Debtors, 5 Op. Atty. Gen. 762 (1831). This opinion is concerned with the construction of an "Act for the relief of certain insolvent debtors of the United States", the question being whether certain creditors who had, before legal insolvency but when they were unable to pay their current debts, given security to private creditors, should be denied the benefit of discharge of their debts to the United States under that act. The Attorney General (R. B. Taney) held that they should be denied such relief, because by giving such security they had intentionally and effectively prevented the priority to which the United States would otherwise have been entitled from attaching and had therefore "fraudulently deprived the

United States of their legal priority" within the language of the act.

Case of Jacob Richardson, 9 Op. Atty. Gen. 28 (1857). Richardson, a collector, died insolvent and in debt to the United States. Before his death, but after his default, he mortgaged land to his sureties for their indemnity. The Attorney General (J. S. Black) held this mortgage not overridden by the United States' priority. (This opinion is set out in full in the Master's report, R. 35).

(3) *Other Authorities.*

Blair, The Priority of the United States in Equity Receiverships, 39 Harvard Law Review 1, 22.

Rogge, The Differences in the Priority of the United States in Bankruptcy and in Equity Receiverships, 43 Harvard Law Review 251, 264.